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**Security Crisis and Economic Interdependence : A Case Study  
of Inter-Korean Trade (2002-2006)**

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**A thesis submitted in partial fulfilment of the requirements for the  
degree of Doctor of Philosophy in Politics and International Studies**

**Department of Politics and International Studies  
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## **List of interviewees**

1. Yu Wan Young. Chief executive, Unicotech Korea. 24<sup>th</sup> July 2008, Seoul, Republic of Korea.
2. Bae Ki Young. Business Advisor, Now Corporation. 19<sup>th</sup> July 2008, Seoul, Republic of Korea.
3. Sung Hyun Sang. Chief executive, Manson Coropration. 22<sup>nd</sup> July 2008, Seoul, Republic of Korea.
4. Ok Song Sok. Chief executive, Nine Mode. Vice president of Kaeseong Industrial Complex Tenant Firms Council. Telephone interview, 21<sup>st</sup> July 2010.
5. Park Heung Shik. Chief executive, Shinwon. Telephone interview, 22<sup>nd</sup> July 2010.
6. Park Nam So. Chief executive, Combase. Telephone interview, 23<sup>rd</sup> July 2010.
7. Chong Kwang Il. North Korean refugee, a former chief of Chungjin Branch of the Chosun Pyongyang Trade Company. 3<sup>rd</sup> November 2009, London, United Kingdom.

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## **Declaration**

The author declares that this thesis is his own work of research. The thesis followed the guidelines established in the Guide to Examinations for Higher Degree by Research of the University of Warwick. The author also confirms that this thesis has not been submitted for a degree at another university.

## **Abstract**

Modern security studies have demonstrated that military insecurity or confrontation create crucial obstacles in trade relationships between states. Unlike this widely accepted conclusion, the trade relationship between the ROK and the DPRK from 2002 to 2006 showed a stable growth despite increasingly hostile political confrontation and military tension caused by the North Korean nuclear program. This study analyzes under what conditions the security instability did not undermine economic interdependence and which factors predominantly affected the actors' behavior by focusing on South Korean SMEs. It will conclude that substantial change of inter-Korean relations after the summit talks in 2000 enabled the SMEs to continue to engage with the DPRK under the nuclear crisis. In terms of what actually motivated SMEs in these transactions, it will argue that South Korean businessmen's desperate desire to look for lower-cost production provided a key driving force for them to risk the military instability. This study will substantiate this argument by providing a result of structured survey of South Korean entrepreneurs who actually were involved in the inter-Korea trade in this particular period. By analyzing how security agenda and economic interest relates each other, this study will overcome either security-dominated or economy-centered bias in capturing the changed essence of inter-Korean relations.

## **Abbreviations**

APEC	Asia Pacific Economic Cooperation
CAPPC	Chosun Asia-Pacific Peace Committee
CASNEC	Civil-headquarters for Activating South-North Economic Cooperation in Korea
CIA	Central Intelligence Agency
CKEC	Chosun Kwangmyungsong Economy Association
DCI	Director of Central Intelligence
DMZ	Demilitarized Zone
DPRK	Democratic People's Republic of Korea
EFTA	European Free Trade Agreement
FKI	Federation of Korean Industries
FTA	Free Trade Agreement
GNP	Grand National Party
HEU	Highly Enriched Uranium
IAEA	International Atomic Energy Agency
IKCF	Inter-Korean Cooperation Fund
IMF	International Monetary Fund
IPE	International Political Economy
IR	International Relations
JCKJD	Joint Committee for the Implementation of the inter-Korean Joint Declaration

KCC	Korea (Chosun) Computer Center
KCNA	Korean Central News Agency
KCRC	Korean Council for Reconciliation and Cooperation
KDI	Korea Development Institute
KEDO	Korea Energy Development Organization
KEPCO	Korea Electric Power Corporation
KEXIM	Korea Export Import Bank
KFSMB	Korea Federation of Small and Medium Business
KIC	Kaeseong Industrial Complex
KIDMAC	Kaeseong Industrial District Management Committee
KIET	Korea Institute for Industrial Economics and Trade
KINU	Korea Institute for National Unification
KITA	Korea International Trade Association
KNIDA	Koryo National Industry Development Association
KOTIC	Inter-Korean Trade and Investment Conference
KRW	Korean Won
KT	Korea Telecom
KWP	Korean Workers' Party
LWR	Light Water Reactor
MDL	Military Demarcation Line
MFN	Most Favored Nation
MIC	Ministry of Information and Communication
MNC	Multinational Corporation

MOAF	Ministry of Agricultural, Forestry and Fisheries
MOFAT	Ministry of Foreign Affairs and Trade
MOSF	Ministry of Strategy and Finance
MOU	Ministry of Unification
NDC	National Defence Commission
NECC	National Economy Cooperation Commission
NECF	National Economy Cooperation Federation
NGO	Non-Governmental Organization
NIS	National Intelligence Service
NPT	Non-Proliferation Treaty
NRC	National Reconciliation Council
NUAC	National Unification Advisory Council
POC	Processing-on-Commission
PRC	People's Republic of China
ROK	Republic of Korea
SBC	Small Business Corporation
SEZ	Special Economic Zone
SME	Small and Medium sized Enterprise
SNCC	South-North Coordination Committee
SPJD	Solidarity for Practice of the South-North Joint Declaration
TCOG	Trilateral Coordination and Oversight Group
TMS	Tae-an Management System
WMD	Weapons of Mass Destruction

WTO      World Trade Organization

# CHAPTER 1

## Introduction

### *1.1 Aims and Research Question*

The aim of this thesis is to investigate the causes that affected the pattern of behaviour of South Korean small and medium sized enterprises (SMEs) in its trade with North Korean counterparts between 2002 and 2006.

In October 2002, the United States suspended economic support committed in 1994, as a reward for the freeze of North Korean nuclear facilities. What became known as the ‘second nuclear crisis’ – following a prior international crisis about North Korean nuclear facilities between 1993 and 1994 – increased political tensions between the Democratic People’s Republic of Korea (DPRK) and the Republic of Korea (ROK) and other international actors. South Korean economic actors needed government permission to engage in trade with the DPRK and thus political tensions might have been expected to make inter-Korean trade more difficult.

The statistical data between 2002 and 2006, however, shows an increase in the number of the South Korean SMEs which engaged in inter-Korean trade. The central research question of the thesis is thus about how we should understand this contradictory phenomenon. This thesis, therefore, aims to answer the question why the South Korean SMEs engaged economically, in terms of inter-Korean trade, with

economic actors in the DPRK between 2002 and 2006, despite increasing security instability caused by the second nuclear crisis.

## ***1.2 Scope***

This section will identify the key actors and key patterns of inter-Korean economic engagement which will be explored in this thesis. Various groups of economic actors carried out various patterns of economic exchanges in the ROK and the DPRK between 2002 and 2006. Although discussing systemic level of full scale exchange was highly premature, actors involved in inter-Korean economic exchanges during this period were not confined to state elites and government agencies. Private firms and workers emerged as new primary actors in inter-Korean economic exchange since the ROK government began to permit trade with the DPRK in 1990. These new actors were joined by interest groups in the South Korean industry and non-governmental organizations (NGOs) that pursued inter-Korean reconciliation through economic cooperation. At the same time, the pattern of inter-Korean economic exchanges too was significantly diversified. The humanitarian aid program toward the North Korean population was a dominant pattern of economic exchanges between the two Koreas before commercial transactions exceeded the government-sponsored relief aid program (KITA 2008). Yet the growing volume of commercial transactions of merchandise began to replace non-commercial economic activities toward the DPRK. Central to this study is a commercial intercourse driven mainly by South Korean small and medium sized manufacturers and their trading partners in the North. Justification of this research focus will be presented in the following.

## *The South Korean SMEs*

Three different levels of actors deserve particular attention in tackling the relationship between political or military conflict and economic interdependence : national, subnational, and supranational actors. When it came to inter-Korean economic affairs, however, intervention by supranational bodies such as multilateral trade organization was not likely at least so far. For example, the non-tariff basis inter-Korean trade since the late 1980s has *de facto* existed outside the Most Favored Nation (MFN) clause in the World Trade Organization (WTO). Given the fact that the volume of the trade between South and North Korea was not considerable, no WTO member country has officially made an issue of the ROK's preferential trade treatment for the DPRK (Ahn D.K.2005). In a bilateral trade relationship between the two Koreas, though observations on national leaders' determination as to how to design a trade regime yielded a set of important findings, inadequate attention has been paid to the role and function of subnational actors. In particular, the behavior of South Korean SMEs, as a main actor that has driven commercial trade with the DPRK, and their strategic interaction with national actors remained largely unexplored. A closer examination on how they react to turbulence of political environment in this regard is needed to fully understand the relationship between trade and security crisis in the Korean Peninsula.

In the context of the South Korean business and industry, domestic corporate actors can be largely divided into two separate groups, that is, the major business conglomerates (better known as *chaebol*) and SMEs. Definitions of SMEs vary depending on the different taxonomies of different industries and individual circumstances of various countries. In this thesis, South Korean SMEs refer to

companies that have below 300 full-time employees. This definition is based on ‘The Basic act of SMEs’ enacted in 1999 by the ROK government. South Korean SMEs have membership of the Korea Federation of Small and Medium Business (KFSMB) whereas large industrial conglomerates become members of the Federation of Korean Industries (FKI).

SMEs in the ROK have existed showing mixed vulnerability both domestically and in terms of inter-Korean trade. They were less vulnerable in domestic economy from the frequent changes of the political environment, which stemmed from the lack of long term business plans and diverse sources of supply and demand for the production planned. But they were more vulnerable in terms of inter-Korean transaction because they were unable to sustain early stage financial loss since they had relatively limited resources.

One could discern this vulnerability of South Korean SMEs in inter-Korean trade more clearly by comparing their predicament with *chaebols*. Chung Ju Yung, the founder and president of Hyundai Group, the second-largest *chaebol* in the ROK, was the first South Korean entrepreneur who visited the DPRK in 1989 since the end of the Korean War. He was a businessman with great success, who had been born and grown up in the North before the division of the Korean Peninsula. He stated in his autobiography that his lifelong wish would be making use of all his investment assets for his separated families and relatives still living in his ancestral homeland (Chung J.Y. 2004). Chung in this visit signed a contract with the DPRK leader Kim Jong Il, Chairman of the DPRK National Defence Commission (NDC), on the joint development plan of Mount Kumkang, one of the most scenic landscapes in the northern half of the

Korean Peninsula, into a tourism resort. Kim Woo Joong, the president of Daewoo Group, also visited Pyongyang two years after Chung's visit. These two men visited Pyongyang before the ROK government enacted a relevant law to legitimize inter-Korean economic exchanges (1990). The ROK government however did not treat it as illegal under the then Roh Tae Woo administration's tacit permission. Unlike this acquiescence in a specific deal conducted by *chaebol*, most of the South Korean SMEs were unable to envisage business in the territory of the DPRK. The lack of government legislation was the main obstacle. This unequal position between *chaebol* and SMEs showed the preferential treatment for *chaebol* by the ROK government in the cross-border commercial transaction with the North before the 1990s.

Until the mid-1990s, overseas Koreans emerged as main investors who were willing to carry out business in the DPRK. These American and Japanese businessmen who were born in Korea and had headquarters in the United States and Japan played a role of intermediary in inter-Korean trade (Park J.K.1997). For example, nearly 90 per cent of the operating joint ventures in the North Korean territory as of 1992, established on the basis of the Joint Venture Law of the DPRK enacted in 1984, was under the investment of the pro-North Korea entrepreneurs living in Japan. The Joint Venture Law had specific provisions to offer the entrepreneurs group who had an investment plan in North Korea preferential measures (Koh H.W. 2002, 95-97). No direct channel of dialogue between the two Korean governments as well as businesses to discuss the modalities of inter-Korean trade existed in the 1990s. As the DPRK refused to hold governmental level talks on trade issues, the necessity to establish a semi-governmental organization to address practical matters on inter-Korean transaction was raised (Kim

K.R. 2000, 92). But still the SMEs that traded with the DPRK partners could not have sufficient backing from the government in comparison with *chaebol* and overseas Korean business groups.

It was in the late 1990s that the South Korean SMEs obtained the government's active support in directly trading with North Korea. The Kim Dae Jung administration that came into power in 1997 announced that preferential loans from the Inter-Korean Cooperation Fund (IKCF) would be provided only to SMEs to invigorate their engagement in inter-Korean trade. The IKCF was established in 1991 to support a wide range of projects to contribute to reconciliation between the ROK and the DPRK. But it was, in effect, not available for private firms until Kim Dae Jung removed this barrier. The inter-Korean summit talks in 2000 between Kim Dae Jung and Kim Jong Il created new business opportunities for the involvement of South Korean SMEs in inter-Korean trade. Pyongyang showed an evolving attitude after this historical juncture toward economic interactions with its former enemy (Eberstadt 2007, 159-163). The industry the DPRK leadership wanted to develop with South Korean capital and resources support was, in the first place, agricultural and light industrial manufacturing to meet the population's basic needs (Yoon D.K and Yang M.S. 2005). South Korean small and medium-sized manufacturers, as a result, were able to secure the prioritized standing, compared to the role of *chaebol*, in inter-Korean trade.

The introduction of the special economic zone (SEZ) in Kaeseong in 2002 by the DPRK government, located just 4 km north of the western part of the military border between South and North Korea, also promoted the increasing engagement of SMEs in inter-Korean business. The ROK and the DPRK government agreed to construct an

industrial complex in Kaeseong allowing South Korean enterprises to operate production facilities by employing North Korean low-waged workers. The Kaeseong Industrial Complex (KIC) provided South Korean SMEs, which were struggling to overcome deteriorating business conditions in China and Vietnam, with fresh opportunities (Lim K.T. and Lim S.H. 2003, 33). The share of inter-Korean trade through the KIC project accounted for 16.7% of total trade volume in 2005 (KITA 2006). The stability of the inter-Korean economic cooperative projects, therefore, was increasingly contingent upon the capability and the willingness of South Korean SMEs running their businesses in connection with North Korea.

### *Inter-Korean trade*

The definition and taxonomy of inter-Korean trade in this study will follow those of the ROK government. The term 'inter-Korean trade' includes a range of flow of goods and capital between South and North Korea.<sup>1</sup> Inter-Korean trade refers to not only transactions that have been conducted, on a commercial basis, mainly by private firms but also on a non-commercial basis economic exchange between the two Koreas such as humanitarian aid from the South to the North. Thus inter-Korean trade is classified by transaction type into two parts : commercial and non-commercial transactions. 'Commercial transactions' include exchanges of manufactured goods/agricultural products ('general trade') and transfer of South Korean semi-processed material and

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<sup>1</sup> The ROK government officially uses terms such as 'carrying-in' and 'carrying-out' instead of 'import' and 'export' to signify the internality of trade between South and North Korea, in which North Korean merchandise carried into South Korea has no liability for tariff. For more discussion on the domestic and international legal issues of inter-Korean transaction, see Ahn D.K. (2005).

parts for production in the North and shipment of completed merchandise to the South (processing-on-commission ; 'POC trade'). It also includes other flows of goods associated with so-called 'economic cooperation projects'. 'Economic cooperation projects' by definition refer to a range of joint projects between the South and the North, with the purpose of reaping economic benefit (MOU 2006). Many of the projects were conducted through FDI-style economic transactions from South to North Korea. In order to be so designated, South Korean companies need the government's approval and are obliged to periodically report what they have conducted with North Korean counterparts. Kaeseong and Mount Kumkang tourism projects are listed as the categorization of the 'economic cooperation project'. The main pattern of general trade was the transfer of North Korean agricultural/fishery products and natural resources toward South Korea. In 2005, for example, 53% of inter-Korean general trade (from the North to South) came from North Korean agricultural/fishery products exports and 20% of them came from zinc nodules. North Korean high-quality metallic ores also had good potential to be exported to neighboring country (Lee J.K 2006, 31). Construction material, factory equipment, and semi-processed materials supposed to be used in the South Korean companies in Kaeseong as well as Mount Kumkang resort facilities are all covered under the heading of economic cooperation projects.

'Non-commercial transactions', on the other hand, refer to (a) humanitarian aid by the ROK government and a range of non-governmental organizations (b) socio-cultural cooperation projects. This transaction category also included the now-defunct light-water reactor (LWR) projects in which the ROK government was a leading participant

responsible for paying 70% of the whole budget to build two light-water reactors in North Korea following the Agreed Framework in 1994.<sup>2</sup>

As of 2005, commercial trade accounted for 65.3% of total inter-Korean trade and non-commercial trade for 34.7% (Lee J.K. 2006, 32-33). Table 1.1 shows the breakdown of inter-Korean trade by transaction type.

Table 1.1 Inter-Korean trade by transaction type

Commercial Transaction	Trade	General trade
		POC trade
	Economic cooperation projects	Kaeseong Industrial Complex
		Mount Kumkang tourism
Others		
Non-commercial transaction	Aid	Non-governmental aid
		Governmental aid
	Socio-cultural cooperation projects	
	Light-water reactor projects	

The share of commercial transactions within the total trade volume was on a continued upswing between 2002 and 2006. For example, commercial transactions accounted for 55.3% (0.36 billion USD) in 2002 and they became 68.9% (0.93 billion USD) in 2006 while the non-commercial trade relative share kept shrinking during this period. This shows the growing engagement of South Korean private firms in trade with North Korea during the second nuclear crisis, in both numerical terms and percentage share. As the scale of POC trade and Kaeseong project grew bigger under the Kim Dae Jung (1998-2002) and Roh Moo Hyun (2003-2007) administrations that pursued extensive engagement policy toward the DPRK, the contribution of private firms to inter-Korean trade became a major part of inter-Korean economic exchanges. Unlike the

<sup>2</sup> On the details of the LWR project agreed between the United States and the DPRK, see Wit et al.(2004).

relief aid and socio-cultural exchanges specifically targeting the North Korean population, commercially driven cross-border trade is likely to be easily affected if politically shaped regional stability encounters turbulent situation. They are normally prepared to move their production facilities and capital seeking a safer and more stable production environment in this globalized economic world in an attempt to avoid geopolitical risk. The behavioral pattern of private firms, particularly SMEs that are vulnerable to political unrest, in this regard is likely to be a litmus test to demonstrate how security risk affects economic interdependence in the region. Particularly the closer observation of how main actors in inter-Korean trade responded to regional instability will demonstrate one of the analytical conclusions on whether inter-Korean trade is not only commercially viable but also politically sustainable amid the continued military tension.

### ***1.3 Original Contribution to inter-Korean relations studies***

This section will identify the contribution of this study to the existing trend of the scholarly and policy analysis of inter-Korean relations and the DRPK by categorizing and critically reassessing the achievements and the limitations of the existing literature in this area. Various attempts have been made to provide a pertinent analytical tool in capturing the essence of the DPRK regime and the relationship with its Southern counterpart over the last 60 years. Whereas one group of analysts paid primary attention to its security dynamic, which constituted a still dominant approach in international relations studies, another began to stress the significance of newly formed economic policy initiatives.

### *Security perspective*

A fundamental assumption of the security-centered perspective on the establishment and development of the DPRK regime was built on the thought that the main driver to determine the regime dynamics and its interactions with external actors was its longstanding security concern. One of the most significant places from which the scholars started exploring this North Korean security issue was Kim Il Sung, the founding leader of the DPRK, and his *Juche*<sup>3</sup> (translated as 'self-reliance') ideology. The North Korean charismatic leader Kim Il Sung who governed the country from 1948 to 1994 and his peculiar ideological doctrine stemming from the traditional roots of Korean antipathy for external domination became a core factor in creating this security-armed 'guerrilla-band-state' (Haruki 1992). Several pioneering researches on Kim Il Sung, particularly his anti-colonial guerrilla movement in the 1930s, contributed to identifying the indigenous roots of the formation of the military-centered regime in the northern half of the Korean Peninsula (Scalapino and Lee 1972, Suh D.S. 1988). Their scholarly attempts were fruitful in that such literature overcame the perspective which had merely described the formation of the DPRK in 1948 as a by-product of the post-War conflict between the United States and the Soviet Union.

The earlier attention on the idea of *Juche* (Cumings 1990, 312-16), as a paramount ideology that had ruled every aspect of the life of the DPRK populations, guided follow-up studies in understanding the DPRK regime. It particularly provided the key means in interpreting 'the socialism of our style' propagated by the DPRK as a response to the collapse of the Soviet Union and the Eastern European socialist regimes in the 1990s.

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<sup>3</sup> For the discussion to literally understand the term *Juche* in Korean linguistics, see Cumings (1990, 313)

As the DPRK faced economic hardship in the mid-1990s, analysts produced articles focusing on the possibility of reinterpretation of the orthodox *Juche* idea by the DPRK authority. This research was increasingly salient as the thoughts of political self-determination and economic autarky included in the *Juche* idea contradicted economic engagement with the external world to revive its economy. In this area, the DPRK researchers discovered the attempts of the North Korean leadership that arranged an escape route by extending the range of *Juche* in an effort to allow the access of foreign resources (Rhodes 1996, Armstrong 1998). What is central to these earlier studies on the *Juche* idea as well as the new findings on Kim Il Sung was the fact that international studies began to perceive the DPRK as a predictable polity rather than an inscrutable and mysterious 'hermit kingdom' beyond the analysis of social science. At the heart of the findings, the top analytical point to explore the DPRK regime was its significant priority on security issues.

Two significant incidents offered a momentum to shift the scholarly concern from the DPRK's internal logic to maintain the regime to the ways in which the DPRK maintained its foreign policy on a variety of fronts. The first nuclear crisis that culminated between 1993 and 1994 drew attention to the DPRK's dealing with international affairs in bilateral and multilateral settings. Scholars analyzed the strategy of DPRK foreign policy at the macro level and its negotiation pattern at the micro level (Kang 1998, Niksch 1998). Western analysts evaluated its foreign policy more broadly focusing not only on its relationship with key allies such as China and the Soviet Union but also on the United States and Japan (Manning 1998, Hughes 1999). The U.S.-DPRK nuclear standoff particularly generated a voluminous literature on the development and

the aftermath of the nuclear crisis in the Korean Peninsula (Mazarr 1995, Cotton 1995, Harrison 1997, Khil Y.H.1998, Sigal 1998, Cumings 1998, Wit et al. 2004, Kim J.S. 2007).

The outbreak of the second nuclear crisis occurred soon after the DPRK government introduced a new economic management system in 2002. It suggested the need for more complex analysis over why the DPRK leadership voluntarily admitted their nuclear program at this particular time. Scholars and policymakers produced various analyses of the second nuclear crisis ranging from accepting it as 'cry for help' tactics to regarding it as an actual threat to the United States (Cha and Kang 2003, O'Hanlon and Mochizuki 2003, Wit 2006). The progress of the six-party talks as a main vehicle that tried to settle the second nuclear debate was critically assessed (Kim T.H.2006, Funabashi 2007, Hong H.I. 2008, Moore 2008). The level of analysis in turn was also expanded to the influence of the U.S. foreign policy on the U.S-DPRK nuclear standoff (Moon C.I. and Bae J.Y. 2005, Pritchard 2007). Despite the long list of literature that had dealt with the first and the second nuclear crises, however, there were few attempts to shed light on the security instability caused by the crisis in connection with DPRK economic relations with external actors.

On balance, the DPRK studies that predominantly followed the trend on its security dynamics implied a shift of research focus from the overall concern on its national identity and history to individual issues such as its foreign policy strategies. A handful of pioneering quests, in addition, to establish an adequate analytical and theoretical framework for the post-Cold War political dynamics of the DPRK regime upgraded the level of analysis in the DPRK studies (Smith 1996, Kim 1998).

### *Economic perspective*

The momentum that brought about growing scholarly interest in the DPRK economy came from the great food shortages that the population had undergone in the mid-1990s. Intensive attention was paid to whether the regime could survive the catastrophic moment where more than a million people, even by conservative estimates, died from starvation or hunger-related illness from 1995 to 1998.<sup>4</sup> Such a move produced various scenarios built upon the prediction of the possibility of the implosion of the North Korean regime likely to be triggered by the already collapsed food rationing system. The prognosis of economic degeneration derived from the famine and decrepit agricultural institutions,<sup>5</sup> most of all, generated pessimistic analyses predicting the imminent demise of the DPRK regime (Eberstadt 1997, Foster-Carter 1998). Other analysts like Noland, on the other hand, made countervailing arguments anticipating the continuation of Kim Jong Il regime under the tutelage of China (Noland 1997). In an attempt to rescue DPRK economy from the famine-caused devastation, Pyongyang's foreign economic relations also attracted growing attention from scholars and policy analysts (Noland 1998, Eberstadt 2007).

A set of economic reform measures announced in 2002, in this sense, was another turning point for the DPRK that began to consider economic prescriptions partly based on market mechanisms, other than ideological means, to overcome its systemic difficulty in economic management. The DPRK government proclaimed the

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<sup>4</sup> Estimates of the number of the North Korean people who died during the great famine varied depending on estimation techniques, for detail, see Noland (2001).

<sup>5</sup> For further discussion on the historical analysis of the DPRK's agricultural institutions as a cause of the chronic food crisis, see Lee S. (2005).

introduction of a series of economic reform programs in July 2002<sup>6</sup>. This reform package centred on an increase of the official commodity prices and the wages of manufacturing workers by readjusting them to a level close to the actual black market price (Kim Y.C. 2002, 14-17, Cho D.H. 2003, 124-145). It also included decentralization measures in production management and distribution. The reform initiatives generated various interpretations about the causes and effects of this unparalleled socioeconomic experiment by the DPRK leadership. The key points of the debate were whether the reform program was aimed at establishing a market economy or not.

Although the DPRK emphasized the need to remedy the defects of the planned economy it had maintained for more than 40 years, there was a discrepancy between their official explanations about the background of the reform and the external observers' assessment. Newcombe (2003, 59-60) interpreted the North Korean experiment for economic restoration as a consolidation of their command economy rather than transforming it. Noland (2003, 29-30), in the same vein, was pessimistic about the future of this reform experiment, pointing out its own macroeconomic instability and the low likelihood of intervention by international development aid agencies. Also for influential policy advisors in Washington, the 2002 reform measures were far from being satisfactory. They asserted that it would fail to meet the North Korean people's demands such as the inception of profit-generating transactions and the assurance of economic

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<sup>6</sup> A set of announcement in July 2002 was named 'measures for improvement on economic management (*Kyongje Kwalli Kaeson Chochi*)' by the DPRK authority. In transliterating Korean into English, *Kaeson* (改善) has a closer connotation to 'improvement' rather than 'reform' which means *Kaehyok* (改革) in Korean. However, the term 'reform' will be used in this thesis in order to be consistent in comparing it with other transitional economies and to embrace more market-oriented subsequent measures put in place later in the DPRK.

transparency (Eberstadt 2004). To put it differently, the 2002 reform measures were, for these Western skeptics, the tool to maintain its moribund regime (McKay 2005, 96).

South Korean policy advisors, on the other hand, interpreted the reform move from Pyongyang as something offering a positive signal for marketization by describing it as an ‘astonishing’ and ‘bold’ choice beyond the external observer’s expectation (Cho D.H. 2003, 121). Smith (2005b, 135-157) and Yoon and Lee (2002) also interpreted it as a revealing signal to introduce market mechanisms into the DPRK economy. Carlin and Wit (2006) shed more light on the existence of a reformers’ group in the DPRK leadership by insisting that the reform was the result of the internal debate between conservatives and reformers within the governing power.

### *Inter-Korean economic exchanges*

The security-centered or economy-focused observation on the DPRK regime tended to lead definitions of inter-Korean relations adopting one of the two biased viewpoints. However, what is closer to the reality was that the actual driving force pushing forward inter-Korean relations is likely to be found somewhere between the conventional security thesis and newly-emerging economic relations. Moreover, given the significant progress of inter-Korean trade amid the nuclear crisis continued, a realistic analysis of inter-Korean relations requires simultaneous consideration of the two factors in a structurally combined manner. Structural observation on how the transformation of security dynamics affected inter-Korean economic relations and the obverse will pave the way for a better understanding of the nature of evolving inter-

Korean relations. But analytical attempts to combine security and economy in an interconnected fashion in interpreting the development of inter-Korean relations were not invigorated in international relations studies.

Inter-Korean economic exchanges under military confrontation were likely to offer an encouraging case study by combining the two elements to capture the essence of inter-Korean relations. But the study on the progress of the economic exchanges between the two Koreas has long stayed on the periphery. Analytical pieces of work, produced mainly in the ROK, to tackle the economic interactions between the two Koreas have largely been confined within policy reports to underpin the government's policy recommendations (Kim Y.Y. 2005). Other analysts provided South Korean investors with practical and strategic guidance they were advised to follow in launching businesses in North Korea (Park H. 2005). Although international relations studies after the meltdown of the ideologically bipolarized world order required greater incorporation of the non-military, non-state agenda into the mainstream strand of analysis, inter-Korean economic relations still remained outside such discussions. Under this external environment, the contradictory phenomenon between the security instability and flourishing inter-Korean economic engagement could not properly be handled.

It was the Kim Dae Jung administration that showed the possibility to incorporate economic exchanges into the ROK government's foreign policy agenda dealing with North Korean regime instability. In response to the economic problems the DPRK had been facing, Kim Dae Jung proposed wide-ranging programs of assistance for the DRPK economy. They aimed at improving the country's infrastructure including transport, electricity, and communications as well as structural support for agriculture to

help avert future famines (Kim D.J.2004). To pursue a comprehensive and integrated engagement policy with the DPRK, Kim Dae Jung introduced an initiative, the so-called '*Jongkyong Bulli*' (政經分離). The term '*Jongkyong Bulli*' meant, by definition, the separation of economic exchanges from the political situation. It implied, as a policy dealing with a hostile nation, that cross-border economic activities should consistently be carried out regardless of, and in spite of, political confrontation (MOU 2003).

The institutionalization of inter-Korean economic exchanges supported by '*Jongkyong Bulli*', after the summit talks between Kim Dae Jung and Kim Jong Il in 2000, generated studies exploring what the ROK government's posture should be in terms of inter-Korean economic transactions. The advocates of the '*Jongkyong Bulli*' initiative insisted that this practical approach, as economic engagement was not affected by the unpredictable rise of military tension, contributed positively to the sustained development of inter-Korean relations (Kim K.R. 2000, Son K.Y. 2006). Their arguments led to support for the government intervention in promoting inter-Korean trade. However, critics argued that the government should 'constructively disengage' from the private sector in pursuing inter-Korean economic transactions (Noland 2000, 352). They stressed that the intervention of the ROK government in inter-Korean trade by private firms would hamper the process of expected marketization of the DPRK economy. Cho Dong Ho (2003, 241) suggested by the same token that the ROK government should introduce a 'flexible inter-linkage' strategy to respond to the need for economic sanctions against Pyongyang which might be caused by the North's provocative actions. These case studies on inter-Korean economic exchanges provided

scholars with a good research topic through which their hypotheses on how to shape a pattern of interaction between politics and economy in the hostile inter-state relationship could be tested.

Although the ROK government sponsored inter-Korean economic exchange in the private sector, the main actors that pushed forward various economic projects were the South Korean SMEs as the *chaebol* avoided getting involved in inter-Korean trade, even after legislation by the government. Moreover, the corporate restructuring program in South Korea, recommended by the International Monetary Fund (IMF) after the financial meltdown in 1997, that had resulted in the phenomenon of ‘low-growth’ and ‘low-investment’, also made South Korean *chaebol* extremely reluctant to push risk-taking investment which might need a longer time to realize revenues (Crotty and Lee K.K. 2002, 2). As a result, the stability of inter-Korean economic transactions was increasingly contingent upon South Korean SMEs’ capability and willingness to engage with North Korean counterparts. South Korean SMEs thereby remained as a principal economic actor in inter-Korean economic engagement. Given the growing importance of South Korean SMEs in inter-Korean economic engagement, it was remarkable to see little scholarly attention on this issue.

Despite the growing significance of the role of the SMEs to inter-Korean economic exchanges, there was little substantial analysis of these developments. The most frequently analyzed point with regard to inter-Korean trade by South Korean SMEs was its low-profitability that ultimately was likely to make it commercially neither viable nor sustainable (Tait 2003, Yoon D.K. and Yang M.S. 2005, Eberstadt 2007). They commonly argued that, as long as the SMEs’ low-profitability structure

continued, inter-Korean trade including POC trade would lack stability, viability, and sustainability.

Although such analyses showed economic insight, a key question still remained unanswered : what made South Korean SMEs continue to trade with North Korea despite the business continuing to lose money ? A couple of intuitive explanations were attempted to resolve this puzzle. Some pointed out the South Korean businessmen's desire to gain public fame as 'patriotic entrepreneurs' (Dong M.H. 2002). They emphasized the willingness of South Korean businessmen to improve their brand values by efficiently attracting more attention from the press, which seemed to be 'pioneering' companies (Han S.J. 2001, 64). These accounts however lacked any evidence to link their likely economic loss and the uncertain and indirect benefit from the 'patriotic and pioneering' but at the same time 'unstable and risky' business. It had moreover limited explanatory power when it came to the South Korean SMEs which drew less media attention in terms of the scale and size of the inter-Korean business.

What is more, scholars paid scant attention to the domestic predicament that had driven South Korean SMEs' trade and investment toward the DPRK. This study will therefore argue that, without consideration about the domestic conditions that the SMEs have faced, revealing the complex variables explaining South Korean SMEs' behavioral patterns in inter-Korean trade is by no means achievable. In that sense, this study on the behavioural pattern of South Korean SMEs in inter-Korean trade under military crisis environment will be a case study to show the inter-relationship between security instability caused by state actors and the economic engagement by the corporate actors in the private sector.

## ***1.4 Theoretical framework***

This section will propose the complex interdependence model developed by Keohane and Nye (1989) as the theoretical framework to understand the background of the substantial change in inter-Korean relations in the wake of the inter-Korean summit in 2000. The section will start by reviewing the literature that addressed the causal relationship between economic interdependence and security dynamics. It will then explain key characteristics of the complex interdependence model and demonstrate its applicability to the case of inter-Korean relations.

### ***Economic interdependence and security***

Modern international relations theories intensively explored the questions of whether and how economic interaction, mainly measured in terms of trade, affects international security relationship. The theoretical arguments linking economic interaction and security had as long a tradition as the classical realist – liberalism debate of international politics.

As a result, it showed a similar division mirroring the contending strands of the classical international relations theory drawn from liberalism and realism. The earlier version of liberal argument on the significance of economic interaction to allay the likelihood of military conflict was created by Richard Cobden in the 1850s. As Cain rightly observed (1979), he simply asserted that international commerce had a panacea-like power in an industrial world to prevent and nullify warfare. Cobden, as an enthusiastic advocate of free trade, went on to argue that even the colonial attitudes by

Western countries in an attempt to acquire rare resources could be restrained by freer trading relationship. Free trade was not only morally required but also commercially efficient instrument, in his idealistic vision, to achieve international peace.

This pacifying effect of trade was reemphasized by Norman Angell (1933) before and even after the First World War. He saw a new ways of thinking, namely commercial-basis trade instead of old method of power politics and war, is able to inhibit a likely interstate violence and as a consequence to promote peace between states involved. States retain greater preference of maintaining trade bonds, according to his formulation, to destruction of the trade partnership in an attempt to pursue a higher ground in political relations. Although war nevertheless breaks out between major powers regardless of the anticipated gain from peaceful trade, it was political leaders' miscalculation or ignorance on the unprofitable result of war that makes it extremely likely, Angell argued.

The liberal arguments that had been made by Cobden and Angell were inherited and more extensively synthesized by Richard Rosecrance (1986). Central to his argument was that states can achieve their goals through trade with other countries than by trying to conquer and assimilate large tracts of land. His neatly summarized argument laid a foundation upon which many other liberal theorists could advance 'trade promotes peace' thesis in a various fashion. The most compelling of these is that trade generates mutual benefit but conflict will destroy it. One of the shared assumptions by the liberals is that political leaders are deterred, before making a decision on whether or not to take military action against key trading partners, by the fear of likely loss or reduction of

welfare gains from trading with them (Oneal and Russett 1997, Doyle 1997, Polachek 1980).

On the other hand, the modern realist understanding of economic interactions and conflict finds its roots in mercantilist thinking dating from the seventeenth century. The mercantilists' fundamental assumption that states need to secure greater control over economically essential goods by lessening economic dependence on other states provides realists with a key logic to develop their argument on the relationship between economic interactions and conflict (Heckscher 1994, Viner 1948). The realists understand that economic interactions will deepen and widen the level of mutual dependence between states and lead to a friction because of the willingness of states to secure the goods they lacked. It has been argued particularly true when the states pursued economic interactions of strategic goods and materials which underpin their security.

For Kenneth Waltz, for example, economic interactions that goes with specialization, in other words international division of labor, brings about high interdependence and in turn states are worried lest they become more dependent on others (Waltz 1979, 160-161). For John Mearsheimer, states may try to extend political control to the source of supply, giving rise to conflict with the source. High level of economic interdependence, therefore, will probably lead to greater security competition (Mearsheimer 1992, 223). In the realist arguments, all in all, strategic security concerns were more emphasized in understanding interstate economic interactions rather than economic short-term benefit. As a result, it was believed that states have incentives to take coercive or even military action to reduce their economic vulnerability from

increased trade and interdependence and to influence its adversary's behavior (Baldwin 1985, Holsti 1986, Liberman 1996).<sup>7</sup>

Despite the prolonged debate between the two contending perspectives, insufficient attention has been paid to the inverse causal mechanism : whether and to what extent militarized conflict affects trade between the two countries involved. Economic interactions, as dependent variable was not necessarily is economic interactions (trade in particular) things are different. Moreover, both realist and liberal arguments on the mechanism were built on the shared assumption that militarized conflict inhibits, if not destroys, the existing level of economic exchanges (Barbieri and Levy 1999, 463-66).

Liberals argue that conflict will disrupt trade or at least adversely affect the terms of trade. The liberal hypotheses were built on the assumption that conflict increases the risk of trade disruption and generally implies the increased cost of doing business. Therefore, they expect that bilateral trade flows will decline as bilateral political relations become less friendly (Pollins 1989a, 1989b, Bergeijk 1994). Realist explanations suggest that the concern over relative gains will lead at least one of the belligerents to terminate trade in order to prevent its adversary from using the gains from trade to increase its relative military power (Greico 1990, Waltz 1979). Employing the realist interpretation, Gowa (1994) expects more trade between allied countries than

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<sup>7</sup> The liberal-realist dichotomy does not apply to other scholars who have sought more synthetic approach. For example, Gasiorowski (1986) distinguishes simple economic interconnectedness and interdependence and argues the former declines conflict whereas the latter leads to increase conflict. Soroos (1997) and de Vries (1990) find that interdependence increases both cooperation and conflict.

with neutrals or enemies. Realist explanation also consolidated the belief that physical confrontation largely hampers the flow of trade between the two parties.

Unlike these widely accepted arguments in IR studies, economic interactions between South and North Korea during the nuclear confrontation (2002-2006) in the Korean Peninsula and beyond showed considerably dissimilar trend to the theoretical assumption. The steady growth of inter-Korean trade and investment made while a hostile political relationship and military tension developed raised the need that the hitherto hypotheses about the influence of militarized conflict on the economic interactions need to be retested.

To elucidate what caused this contradictory move, this study will, in the first half of the thesis in particular, demonstrate substantial change of actors and dynamics that had framed inter-Korean relations and attempt to explain it by the complex interdependence proposed by Keohane and Nye (1977). This study will argue that the evolved pattern of inter-Korean engagement which is akin to the complex interdependence situation, offers a useful framework under which the South Korean SMEs' domestic interests worked with continuing their economic engagement in trade with the North. At the same time it will also point out a limitation of this model in fully analyzing the inter-relationship between economy and security in inter-Korean affairs.

Direct application of the model to the whole of inter-Korean relations throughout the period after the Cold War is not convincing at all. However, this study will argue that the economic, cultural and human exchanges between South and North Korea, particularly after the inter-Korean summit in 2000, can be understood through the

asymmetrical interdependence model (Keohane and Nye 1989, 16-18) in a bilateral relationship.

### *Complex Interdependence model*

The complex interdependence model spawned from the post-war period realism-dominated IR studies and the challenges by a group of thinkers. After the wars, classical realist arguments gained undisputable explanatory power in analyzing the then interstate relationship and predicting how the relationship is going to develop in the future post-war world by predominantly emphasizing the supremacy of power, security, self-interest, and conflict in IR studies. They acknowledged a state as the only rational actor in international relations and inter-state cooperation is highly unlikely even by accord or law in anarchical nature of international politics in realist understanding (Morgenthau 1948).

On the other hand, other group of thinkers suggested that states can cooperate within commonly agreed economic and political framework for their mutual benefit. As Mitrany argued, the cooperation between states initially occurs in technical areas where it was mutually convenient, but once successful it could 'spill over' into other functional areas (Mitrany 1948, 350-63). In this regard, cooperative probability through non-governmental elites, one of the foundational claims of functionalism later constituted the key notions in developing interdependence theory.

It should be noted, as Richard Cooper (1968) asserted that all economic relationships entails costly aspects, the theory of interdependence initially developed

from the need to assess the costs, in other words, the burdens of adjustment forced upon them, generated by the economic and/or political interactions rather than the benefits a state can acquire from the exchange with other countries.<sup>8</sup> However, by demonstrating ‘opportunity costs of severing the existing relationship’ (Baldwin 1980, 481-486) a group of interdependence theorists successfully transformed it into an efficient tool to explain a motive for cooperation rather than a source of conflict. Among them, Robert Keohane and Joseph Nye suggested extensive view to shed light on the cooperative relationship between states without recourse on military force by formulating a new ideal type of international relationship called complex interdependence.<sup>9</sup>

Such an attempt was a challenge to the IR scholars who had paid intensive attention to the use of economic means such as trade for the purpose of accomplishing a state’s security objective in a political arena. Since Albert Hirschman (1945) had published his pioneering work on the power and influence of economic means – quotas, exchange control, and other instruments of economic warfare – in establishing and developing statecraft, economic interactions between states has largely been studied as part of national foreign policy to enhance relative gain of the particular state (Baldwin 1985).

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<sup>8</sup> Realist explanations on the interdependence consistently emphasized vulnerability aspects of interdependence, indicating political weakness coming from dependent relationship with others. See Waltz (1979,138)

<sup>9</sup> Keohane and Nye published the first edition of *‘Power and Interdependence’* in 1977. Ten years later, they published a fresh article entitled *‘Power and Interdependence revisited’* to respond to the criticisms which had been made by both liberals and realists over the intervening ten years. They reformulated the relationship between military force and economic means as a bargaining tool under complex interdependence in this article. As they published the second edition of *‘Power and Interdependence’* in 1989, they included the revised version of *‘Power and Interdependence revisited’* as an afterword for a fuller discussion. In this thesis, the second edition of *‘Power and Interdependence’* will be used as the main text from which the authors’ conceptions will be cited.

However, Keohane and Nye showed that two states can be brought together not only by state to state diplomacy but also by involvement of a variety level of non-state elites. Under the complex interdependence model they theorized, interstate interactions is likely to occur outside of the realm of statecraft by government, attracting multiple actors in multiple issue areas through multiple channel among societies. Further, Keohane and Nye made a contribution to building a comprehensive theoretical structure to address how the various level of individual actors create a web of cooperative structure by widening their scope of analysis from simple bargaining practice to systemic approach to the international politics.<sup>10</sup>

Complex interdependence, as a notion to fill the theoretical space that realists insufficiently explained, has three main characteristics. Firstly, under complex interdependence in international relations, interstate interaction comes from the informal ties among non-governmental elites such as business persons and academics, as well as intergovernmental dialogues. The non-governmental elites are able to create their own communication channels by the development of telecommunications without being entirely controlled by governments. Secondly, under complex interdependence, the foreign affairs agendas become increasingly broader and more diversified. The sets of interstate agendas also lack hierarchy among themselves as the distinction between domestic and foreign issues becomes blurred. Military security that political realists exclusively emphasized no longer dominates other multiple issues representing the interests of various domestic groups. Thirdly, complex interdependence caused a

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<sup>10</sup> But it does not rule out the use of complex interdependence model to analyze a dyadic level relationship. One of the major parts of their case studies in '*Power and Interdependence*' focused on America's bilateral relationship with Canada and Australia. See ch.7 in Keohane and Nye (1989).

decrease in the influence of military force as an instrument to achieve an individual nation's goals. Military force showed limited usefulness and lost its prior standing as a dominant source of power as it was costly and uncertain in the era of complex interdependence (Keohane and Nye 1989, 24-29).

The changing features of international relations also affected the political process related to intergovernmental bargaining between strong states and weak states. In the international relations that political realists had portrayed, strong states tended to dominate a variety of issues by linking their own policies on some issues to other states' policies on other issues. The preponderance of military capability thus implied a dominant bargaining power demonstrating the political high ground to coerce a negotiating partner in the non-military issue areas such as trade disputes. Military priority was the physical source of power to make a stronger state achieve its political and economic goal by linking it to different issues in which the other states were likely to have inferior conditions. Significant progress has also been made in issue-linkage tactics through producing various patterns of those tactics (Oye et al. 1979, Haas 1980, Stein 1980).

Under complex interdependence, however, the issue linkage strategy of strong states became less effective. The lack of hierarchy among issues made the strong states' attempts at the linkage strategy more problematic. This was particularly likely when the military force of a strong state was nullified for the purpose of intimidating the bargaining power of its counterpart aiming to protect national interest in non-military issue areas. Poor and weak states, instead, were able to link unrelated issues because their domestic interests were less complex in comparison with those of economically

advanced states in which a variety of interest group contested one another even within the government. Poor states could utilize the linkage strategy of unrelated issues as a means of extracting concessions or side payments from rich states (Keohane and Nye 1989, 30-31).

### *Inter-Korean relations and the complex interdependence model*

The changed nature of inter-Korean relations after the inter-Korean summit illustrated the decreasing explanatory utility of statecraft discourse approach that emphasized the security dominance in international relations. The statecraft approach by a militarily or economically strong state shows a swing of the pendulum between integrated and separated pursuit of economic and security objectives depending on how much dominant the strong state's power to control the international order is in the particular period. The principle aim of the approach was to understand a stronger state's attempts to preserve its preponderance over a weaker state in international politics (Mastanduno 1998). But accentuation of the complex interdependence model lies not on one dimensional 'influential' *vis-a-vis* 'being influenced' relationship between a stronger and a weaker state. The model calls the unitary dominant role of state into question and rather stresses emerging transnational and transgovernmental contact channels between states indicating diversified engagement routes that undermined traditional diplomatic relationship (Keohane and Nye 1989, 33-35).<sup>11</sup> In a changing interstate relationship, the model showed a possibility in which non-governmental actors

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<sup>11</sup> On the more detailed formulation of transnational and transgovernmental contacts in international politics, see Keohane and Nye (1972) and (1974) respectively.

from each country can collaborate, if not create a coalition, resulting in economic and social transactions among 'societies'. As a result, the complex interdependence model draws more attention to the alternative role of economic engagement by non-governmental and subnational actors in various issue areas.

Inter-Korean trade by private firms and many other economic and social exchanges between the two parties even under the situation of the volatile security dynamics provides an empirical evidence to support the applicability of the complex interdependence model as a framework of analysis of inter-Korean relations after 2000.

Since the ROK government legitimated inter-Korean economic transactions by private sectors in 1990, the absolute prohibition of non-governmental contact between the two Koreas was lifted. South Korean private firms began to import agricultural and fishery products from the North and to export their products to the North subject to the government permission. But it was after the two Korean leaders met and agreed that various channels for economic cooperation and information sharing, like cultural and academic exchanges, actually became a normal part of the inter-Korean relationship (Kim K.R.2000, Oh S.Y.2001).

After the inter-Korean summit talks in 2000, exchanges between the two Koreas in non-political and non-military issues showed a dramatic increase. The number of South Korean people who visited the North, was 5,599 in 1999 but it reached 100,838 in 2006 (MOU 2007, 8-9). The purposes of these visits varied, ranging from the performance in Pyongyang by a South Korean pop singer to the joint publication of a Korean language dictionary (MOU 2007, 12-13). These various events were separately put forward and implemented by the individual organizers. Neither priority nor inter-agenda hierarchy

was required by the government in arranging the individual projects. The South Korean government did not prohibit the cooperative projects pushed forward by the agreement between the South Korean organizations and its North Korean counterparts.

The influence of military force that had dominated the inter-Korean relations since the end of the Korean War in 1953 also declined as a result of the increasing human and cultural exchanges. The military authorities in the two Koreas, for example, held high-level talks from 2004 and reached an agreement signalling substantial changes in the history of inter-Korean military confrontation. It included an agreement to prevent accidental military collision in the Yellow Sea and to dismantle the broadcasting facilities that had been used as a main vehicle to slander each other across the Demilitarized Zone (DMZ) between the Koreas (*Yonhapnews* 5<sup>th</sup> July 2005).

The increasing inter-Korean economic engagement in the various issue areas occurred at the same time as the two Koreas managed to achieve a peaceful coexistence strategy, at least temporarily, after the 2000 summit agreement. Military issues as the only predominant negotiation agenda that had defined the post-Korean War relationship between the two countries began to lose a top priority amid a rising mood of inter-Korean cooperation. The more significant strategic goal, for both parties, was not to entrench military preponderance but to secure material and economic gains during this period.

These fundamental changes shown in the evolving pattern of inter-Korean ties after 2000 reflects key characteristics of the complex interdependence model. The unprecedented multi-level exchanges and cooperation in multiple issue areas significantly corresponds with the key assumption of the complex interdependence

model. This also shows that the transformation of inter-Korean ties suggests the Korean version of complex interdependence was taking root after 2000 as a result of dramatic growth of inter-Korean exchanges quantitatively and qualitatively. The complex interdependence model in this sense, subject to further amplification on state capacity, provides one of the most effective theoretical frameworks to explain the pattern of change in inter-Korean relations from 2000 to 2006.

### *1.5 Hypotheses*

Three hypotheses will be suggested in this section in order to identify the main driving force for South Korean SMEs to enhance their economic engagement with the DPRK, despite the security tensions caused by the second nuclear crisis between 2002 and 2006. These hypotheses were drawn from a series of changes in both Koreas' political economy between 2002 and 2006 and consisted of two pull factors and one push factor. The two pull factors came from the policy change by the ROK and the DPRK government respectively and the push factor derived from the changed business conditions in the ROK. This study assumes these three factors alike promoted inter-Korean economic engagement by South Korean SMEs during the nuclear crisis and tests the respective hypotheses employing a semi-structured survey and a variety of relevant literature.

Firstly, the ROK government provided the SMEs which were involved in inter-Korean trade with a set of economic incentives. The preferential treatment for South Korean traders who engaged with the North included direct financial subsidies as well as tax incentives. The ROK government had funded over 6 billion KRW (some 6

million USD) by the end of 2005, for the purpose of offering lower interest rate loans than private commercial banks for firms participating in inter-Korean business (MOU 2008). The Inter-Korean Cooperation Fund (IKCF) run by the Korea Export Import Bank (KEXIM), the South Korean parastatal bank, covered unforeseen financial losses which might be caused by any North Korean breaches of existing contract. This financial subsidization policy hypothetically encouraged the engagement of South Korean SMEs in inter-Korean trade. South and North Korea, moreover, did not levy tariffs on inter-Korean trade by treating their economic activities as 'intra-national' transactions. Non-tariff trade between the two Koreas also provided the South Korean traders with favorable conditions to keep their business costs down. Such preferential tariffs were likely to motivate South Korean traders to choose transactions with the North Korean partners rather than with other countries, if other terms of trade were equal (Oh S.Y. 2001, 168-170).

Secondly, a series of measures to improve North Korean economic efficiency announced in July 2002, just before the second nuclear crisis erupted, could be assumed as an encouraging signal for further development of inter-Korean trade. This announcement did not contain any specific provisions spelling out economic engagement with the ROK. However, the DPRK government's support for a market-oriented environment through its promotion of a decentralized economic management system was likely to motivate South Korean SMEs to increase their transactions with the North. If the first hypothesis explained the initial motivation for South Korean SMEs to engage with the North Korean counterparts, this reform signal projected by the 2002 announcement further consolidated the progress of inter-Korean economic engagement.

To explore whether and to what extent such a reform experiment affected the scale and pace of inter-Korean trade, this study will examine the past and present of North Korean attempts for economic change. The reform idea to change the centrally-planned autarkic economy, through measures such as economic openness, decentralization, and the introduction of the profit motive in economic management since the 1980s will be examined. Debate over the real intention of the reform drive will also be explored to identify the achievements and limitations of the experiment. This study will ultimately show to what extent this economic reform signal actually affected the South Korean SMEs' behavior in engaging with North Korean economic units during the nuclear crisis.

Thirdly, this study assumes that the worsening business environment in the ROK promoted the SMEs' quest to find alternative production sites in the DPRK. In this assumption the threatening situation triggered by the nuclear crisis was likely to be considered as a surmountable risk as long as the ROK government continues its engagement policy. Unfavourable business conditions included high labor and land costs along with South Korean workers' increasing reluctance to participate in the low-wage based simple manufacturing industry. The ROK government, on the other hand, gave priority to small and medium sized exporters to move into the KIC which resulted in signalling even higher growth in inter-Korean trade. The government provided such preferential measures particularly for less competitive marginal industry such as apparel and footwear manufacturing. The ROK government's policy that had preferred SMEs as key participants in inter-Korean trade shaped the KIC as a light industry-led production complex. For example, apparel and textile manufacturers that had failed to maintain cost competitiveness due to the influx of even cheaper products made in Vietnam and China

accounted for sixty per cent of the tenant companies in the KIC as of June 2009 (KIDMAC 2009). South Korean SMEs' desperation to survive in an increasingly competitive business, according to this hypothesis, outweighed their increased risks caused by the political turbulence surrounding their business in the DPRK.

### ***1.6 Methodology***

A key methodological task in this study is to test the three hypotheses to identify a primary factor that motivated South Korean SMEs to continue to engage in inter-Korean trade under the nuclear crisis. Each hypothetical element will be comprehensively explained in the first place to demonstrate how likely it was that it contributed to South Korean traders making the decision not to slash their trade volume with the DPRK during the crisis. On this basis, a semi-structured questionnaire will be drawn up for the purpose of conducting a survey of South Korean traders who actually transacted with North Korean counterparts between 2002 and 2006. The result of this survey will provide a key evidence for this study to conclude that South Korean SMEs' predicament in domestic industry was a predominant factor that drove them to keep engaging with the DPRK in spite of the crisis.

The questionnaire of this survey is organized into two parts. The first section is designed to see how the South Korean traders perceived the influence and ramification of the nuclear crisis and to what extent it was likely to affect their inter-Korean business. The central point in this part is two fold : (1) whether and how much the nuclear crisis influenced their decision-making in terms of trade volume (2) what were the causal

variables affecting their relevant decisions in connection with the three hypotheses presented above.

The second half of the survey contains relatively more generic questions to show the consequences that resulted from Kim Dae Jung and Roh Moo Hyun's engagement policy toward the DPRK after 2000. It is designed to investigate the influence of political changes on economic relations between the two Koreas. This part of the questionnaire will particularly reveal the diversified inter-Korean contact channel for economic engagement which fits in large part the assumption of the complex interdependence model.

The questionnaires were circulated through the network of the Korea International Trade Association (KITA), the largest institution to which most of inter-Korean traders belong. The respondent group was selected based on the membership list of the Inter-Korean Trade and Investment Conference (KOTIC), a subunit of KITA specialized in inter-Korean trade. The questionnaires were distributed to the chief executives of a hundred inter-Korean traders by facsimile transmission in connection with telephone conversations. The KITA and KOTIC network was regarded as the most trustworthy route to collect data from individual inter-Korean traders since they had maintained periodical contacts with them in order to regularly identify any likely obstacles and red tape in carrying out a range of inter-Korean transactions. The ROK government statistical data that have been compiled by the Ministry of Unification (MOU) also relied on the data collected through this network. The survey through this network for this study was conducted from 20<sup>th</sup> July to 25<sup>th</sup> August in 2008 and the response rate was 40 out of the 100 copies that had been circulated.

Other source material for this study apart from the survey results will include primary sources and interview data, as well as secondary literature. Statements of the ROK government institutions and other literature authored by former key decision-makers on inter-Korean affairs have been collected and analyzed. Existing survey results, mainly conducted by the South Korean quasi-governmental institutions will also be employed to take a look at the perception of the inter-Korean traders on the present profitability, future prospects of inter-Korean trade and their response to the relevant government policy. This data will be helpful in demonstrating how and on what basis the South Korean SMEs responded to the external environment surrounding inter-Korean economic transactions. In-depth interviews were conducted to investigate individual entrepreneurs' experiences as to how the North Korean people's attitude changed with regard to economic engagement with the South Korean counterparts during the second nuclear crisis. The interviewees were selected from those who were significantly involved in inter-Korean trade from 2002 to 2006, subject to their willingness to testify their experiences. The interview data will support the survey result by adding another dimension of evidences based on the South Korean entrepreneurs' own episodes in dealing with front line trade partners in North Korea. The interviewees will also include a North Korean refugee, a former high-ranking official of Pyongyang-based trade organization, who can explain how inter-Korean trade developed during the crisis from the perspective of the DPRK.

A methodological barrier to this study is asymmetric access to information produced in the ROK and the DPRK. Obtaining internal information in the DPRK was not as easy as in its southern neighbor. Although there have been many primary sources

announced by the DPRK leadership – party, cabinet, and other subordinate institutions – the lack of critical voices opposing the government policy made it difficult to achieve reliability and objectivity. Such an asymmetry of scientifically reliable information between South and North inevitably resulted in heavily relying on the data and sources in South Korea even in collecting North Korea-related data. However, an increasing number of North Korean refugees and defectors who had settled in South Korea and their testimonies were able to, at least in part, compensate for this asymmetric information problem. The secondary literature produced by South Korean scholars in the 1990s and the 2000s involved growing number of interview data with North Korean escapees. The contributions by the North Korean defectors enhanced the explanatory power of the literature in interpreting causes and consequences of internal dynamic in the North Korean regime. This study largely relies upon data and information collected in the ROK including North Korean defectors' testimonies. But at the same time it examines North Korean state media and literature, accessible in the South Korean scholarly institutions, to explore the internal logic supporting the changes that occurred in the DPRK in connection with its foreign economic policy.

### ***1.7 Outline***

This thesis is divided into two major parts. In the first half which contains chapters 2, 3, and 4, the two pillars constituting this thesis – increased security tension and inter-Korean trade – will be intensively discussed. The three hypotheses mentioned in the above section will be tested respectively in the second half (chapters 5, 6, and 7) to answer the key research question of this study.

Chapters 2 and 3 will suggest an analytical framework to interpret the transformation of inter-Korean relations after 2000 by focusing on key differences before and after the inter-Korean summit talks. More specifically, chapter 2 will analyze the development of inter-Korean relations before 2000 by focusing on the security-dominated relationship between the two Koreas. After reviewing the political and military dynamics between the United States and the DPRK, as a predominant element that has shaped security environment in the Korean Peninsula, the chapter will formulate a realism model-based explanation on inter-Korean relations. Chapter 3, on the contrary, will argue that the exchanges and cooperation projects implemented as a result of the Inter-Korean Joint Declaration in 2000 undermined the state/military-centric foundation of the inter-Korean relations since the 1950s. The chapter will demonstrate how this changed security environment in the Korean Peninsula engendered new actors and issues as well as new communication channels in inter-Korean interactions by highlighting the achievement of the former ROK president Kim Dae Jung and Roh Moo Hyun. A survey result suggesting this changed contact route will be presented in this chapter. The chapter as a consequence argues that the viewpoint of political realism, which has dominantly construed inter-Korean relations since the end of the Korean War, no longer provides appropriate perspective as an analytical tool. It will then propose the complex interdependence model as a new analytical framework to interpret this substantial change.

Chapter 4 will contrast the heightened military tension in the Korean Peninsula caused by the second nuclear crisis and the increasing trend of the inter-Korean trade from the eruption of the crisis to 2006. A detailed chronology showing the escalation of

nuclear tension and the responses of relevant players will be presented in this chapter. To illustrate a stable growth of inter-Korean trade, various dimensions of quantitative statistical data showing the upswing of the inter-Korean trade will be employed. It presents inter-Korean trade volume by sub-categories and the number of companies which were actually involved in these cross-border transactions. This chapter will also analyze the subsequent ramifications of inter-Korean trade under the situation where the hostile relationship did not yet come to an end. One of the central perspectives to observe this ramification will be how the mutual engagement by subnational actors ensures the continuity of the relationship in spite of rising tension.

In the second half of this thesis, three hypotheses explaining the increasing economic engagement by South Korean SMEs during the second nuclear crisis will be discussed one after another. Chapter 5 examines the first hypothesis : the direct financial incentives from the ROK government to promote inter-Korean trade. Whether or to what extent the preferential measures granted by the IKCF contributed to facilitating more sustainable commercial transactions with North Korean trade partners will be tested in this chapter.

Chapter 6 discusses the second hypothesis. This chapter will, first of all, trace the historical background of the economic reform programs announced by the DPRK government in 2002, just several months before the outbreak of the second nuclear crisis. It will also highlight the debatable intentions, characteristics, and the influence of this reform package. This chapter will ultimately explore whether these economic reform measures affected South Korean SMEs decision on inter-Korean trade volume.

Chapter 7 will shed light on the deteriorated business environment in the ROK as a main push factor that precipitated South Korean entrepreneurs' efforts to find out an alternative production base in the DPRK. Increasing labor and land costs along with South Korean workers' reluctance to participate in low-wage based manufacturing industry promoted their attempts to move the production facilities. This chapter will offer an argument explaining the engagement toward the North by the South Korean marginal industries such as apparel and footwear that faced difficulties in the domestic market.

Additionally, the results of the survey conducted in the ROK will respectively be presented in chapters 5, 6, and 7 to show why the South Korean entrepreneurs continued to push forward inter-Korean trade despite the unstable political climate. Chapter 8, the concluding chapter, will summarize the main findings of the thesis and suggest their implications on the ROK government policy to improve inter-Korean relations. Recommendations for future research on inter-Korean relations will also be made at the end of the thesis.

## ***1.8 Conclusion***

In this chapter, the dominant perspectives which will frame this thesis were intensively discussed. This thesis will first of all attempt to explore the inter-relationship between the increasing security instability and the economic engagement between potentially hostile actors. It will examine, as a subject for case study, the changing trend of the cross-border trade between the ROK and the DPRK amid the growing military tension caused by the second nuclear crisis sparked in 2002. The statistical data between

2002 and 2006 showed by and large an ascending trend in cross-border trade between the two Koreas despite the increasingly unstable security environment in the Korean Peninsula. To explore the causal variables which affected the increasing inter-Korean trade under the security instability, this thesis sets out three hypotheses. Firstly, the economic incentives such as the financial subsidization and the tariff exemption for South Korean SMEs will be assumed as an influential factor to promote the inter-Korean trade after the outbreak of the second nuclear crisis. Secondly, a series of North Korean economic reform packages announced in 2002 will be examined as the external variable that facilitated the active engagement of South Korean SMEs in inter-Korean trade. Finally, the deteriorating business environment in the ROK will be intensively discussed as a push factor for South Korean SMEs to risk an unstable security situation to secure low-cost production sites. By testing the validity of each hypothesis, this thesis will conclude that the domestic business conditions primarily affected the South Korean business community's behavioral pattern on whether and how deeply to engage with the North Korean economy. This finding ultimately implies that there was no specific pattern of causal relationship between economic interdependence and nuclear crisis as long as inter-Korean channels at multiple levels were maintained.

## CHAPTER 2

### Inter-Korean relations before 2000

#### ***2.1 Introduction***

This chapter will analyze the development of inter-Korean relations before 2000 by focusing on those of the 1980s and 1990s. The central analytical point would be the relationship between economic interdependence and security concern. After reviewing the political and military dynamics between the United States and the DPRK, as a primary causal variable that has framed the security environment in the Korean Peninsula, the chapter will explore the key features of inter-Korean relations during this period. This chapter will, by doing so, show that political realism in IR theory provides a decent analytical framework to explain inter-Korean relations before 2000.

#### ***2.2 U.S-DPRK relations under the Clinton administration (1993-2000)***

This section will discuss three main points. Firstly, it will analyze the origin and development of the notion of 'rogue state' presented by the Clinton administration in the 1990s.<sup>12</sup> This will provide the groundwork to understand the key concept which framed

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<sup>12</sup> The term 'rogue', 'backlash', 'outlaw' and 'pariah' were used interchangeably in policy and academic discourse. Alexander George (1993, 49), for example, used the term 'outlaw states and their rogue leaders'. In this chapter, the 'rogue state', as a term that enjoyed more currency among Korean issue analysts as well as American policymakers, will be used for consistency.

the Clinton administration's viewpoint on the DPRK. Secondly, it will examine the literature of proponents and opponents of the 'rogue state' in adopting this notion to analyze the DPRK case. It will show there was no consensus in DPRK studies regarding the applicability of the 'rogue state' notion. Thirdly, it will argue that the attempts to apply the 'rogue state' notion to the DPRK case resulted in consolidating inter-state military dynamics in understanding the security environment in the Korean Peninsula.

### *Origin and development of a 'rogue state'*

American foreign policy advisory groups were the main source behind the creation, shaping, development of the concept of the 'rogue state'. They used the term 'rogue state' as political and diplomatic rhetoric. Alexander George (1993, 49) highlighted the 'rogue states' non-compliance with the norms of the international system. He argued that 'rogue states refused to accept and abide by some of the most important norms and practices of the international system. Anthony Lake, President Clinton's national security advisor, also paid great attention to the 'rogue states' aggressive behavior and their chronic inability to engage constructively with the outside world. He argued that their pursuit of weapons of mass destruction (WMD) made clear their inclination to remain on the wrong side of history (Lake 1994, 46). President Clinton also stated that "rogue states posed a serious danger to regional stability in many corners of the globe." (Clinton 1995).

This conceptualization, by the key officials and the advisors in the U.S. government, of 'rogue state' alarmed international actors about the catastrophic

consequence they might bring about. George argued that rogue states might seek to dominate and reshape the system to their own liking. He warned that they might aim at regional hegemony (George 1993, 49). Madeleine K. Albright, Secretary of State in the Clinton administration, asserted that the rogue states' sole purpose was to destroy the international system (Albright 1997).

What the Clinton administration attempted to highlight was the American role and its responsibility in coping with rogue states. The Clinton administration repeatedly emphasized that the United States ought to 'socialize' and 'reform' rogue states (George 1993, 49). Such responsibility included the American role for developing a strategy to 'neutralize', 'counter' and 'contain' them through selective pressure (Lake 1994). The Clinton administration wished to articulate and achieve a post-Cold War containment doctrine by insisting on American hegemony in responding to the rogue states' aggression. The Clinton administration's notion of the rogue state superseded the foreign policy agenda toward the Soviet Union during the Cold War (Litwak 2000, 3).

### *Rogue state and the DPRK*

The DPRK was not a main component in the original rogue state categorization. Anthony Lake identified Cuba, Libya, North Korea as well as Iran and Iraq as 'backlash states' in his article published in *Foreign Affairs* in 1994. Iran and Iraq were indeed the main targets of what he called 'dual containment'. He presented this strategic initiative toward Iran and Iraq for the purpose of reconstructing the Middle East policy of the United States (Lake 1994, 48-49). However, since the inclusion of the DPRK in Lake's

article, the rogue state discourse has provided scholars and policy analysts working on the DPRK issues with an analytical tool. A number of scholarly analyses on North Korea focused on finding out the similarities and distinctions between the DPRK and a group of Islamic states such as Iran and Iraq (Henriksen 2001, Litwak 2003-04, Howard 2004, Huntley 2006). In contrast, historical, religious, geopolitical peculiarities, within which the DPRK had been established and transformed, were underestimated.

A handful of policy reports following the logic of rogue states neglected non-state actors, which fell outside the 'rogue or non-rogue' dichotomy. William C. Triplett, chief Republican counsel to the U.S. Senate Committee on Foreign Relations, regarded North Korean non-state actors, such as its population, as mere puppets that were forced to obey the rogue regime.

Foreigners who visit North Korea notice the people won't make eye contact and any conversations are stilted and ritualistic. Those who have not been brainwashed into submission have been terrorized (Triplett 2004, 6).

In making this point, however, he did not provide any evidence based either on extant scholarly literature or on his own interviews. The most visible evidence mobilized in order to stress the rogue nature of the DPRK regime was the description of the North Korean political leader's private life, drawing attention to the marble palaces, hunting lodges, women, liquor, jet skis etc. (Triplett 2004, 5). This approach significantly impeded paying attention to the North Korean agencies and institutions which framed its foreign policy and in turn created a broader Korean security

environment. Journalist Jasper Becker (2005) also showed inattention to influential actors engaged in the DPRK foreign policy. He simply presented fragmentary political episodes, observed through the rogue state discourse, under what he called the Kim Dynasty.

On the other hand, there was no indisputable consensus over the inclusion of the DPRK among rogue states within international institutions. The United Kingdom, for example, as one of the Permanent Five in the United Nations Security Council, demonstrated a different approach regarding its diplomatic relations with the DPRK. British delegates in 1991, including two diplomats and seven Members of the House of Commons, visited Pyongyang to take part in the 85<sup>th</sup> Interparliamentary Union Conference. This event marked a significant step forward in the relationship between the UK and the DPRK (Morris 1996, 89-90). A group of British scholars, in the same year, also participated in the first UK-DPRK social scientists' seminar in Pyongyang, hosted by the *Juche* Academy (Smith et al. 1997, ix). These episodes demonstrated that the notion of rogue state was not a universal concept that already obtained consent from key state actors in international politics.

Scholars produced, at the same time, critical assessments on the rogue state discourse *per se* and, in particular, its applicability to the DPRK case. Chomsky (2000) argued that the United States was not qualified in attempting to demonize the hostile state toward itself. Smith (2000, 115-19) pointed out that viewing the DPRK as a rogue state generated poor policy choices. She argued that its logic failed to grasp the complexity of North Korean politics. Dujarric (2001) criticized the criteria the U.S. considered when branding hostile nations as rogue states. He argued that the

demarcation between rogue and non-rogue states - human rights violations, possession and trade of WMD - was not impartial. He provided other examples such as Saudi Arabia, Egypt (human rights violation) and India, Pakistan (nuclear possession) in order to substantiate his criticism.

### *Inter-state military dynamics*

The debate over a rogue state and its applicability to the DPRK resulted in confining the analytical tool viewing the DPRK within inter-state political dynamics. The literature of the rogue states emphasized the imminent risk of a military clash in the Korean Peninsula. They also demonstrated the neglect of the role of sub-state actors in the Korean security environment. They instead consolidated the significance of state-centric dynamics as a method to analyze the security environment in the Peninsula. The rogue state literature also highlighted the feasibility of a 'one-size-fits-all' strategy (Litwak 2000, 9), which could be applied to every rogue regime including the DPRK. Their overarching assumption in the DPRK studies was that Kim Il Sung and his successor Kim Jong Il was the only determinant in underpinning their security concern. This meant that the security environment in the Korean Peninsula was built on this state-centric security dynamic. Scholars paid scant attention, in contrast, to the reality and possibility of various levels of interactions between the DPRK sub-state agencies and the rest of the world. As Sigal pointed out, during the Clinton administration, primitive realism took the place of pragmatism as an analytical tool to view the security environment in the Peninsula (Sigal 1998, 13). This state-centric realistic approach

continued in the Bush Administration. The emergence of global terrorism, furthermore, consolidated the U.S. containment strategy against its political adversaries.

### ***2.3 Inter-Korean relations before 2000***

This section will investigate the development of inter-Korean relations in the late 1980s and the 1990s focusing on inter-Korean economic interdependence and security concern. The section will assess the North Korea policy of the former ROK presidents Roh Tae Woo (1988-1992) and Kim Young Sam (1993-1997) in association with military tension in the Korean Peninsula and the emerging economic interdependence. It will argue that the security-dominated realist perspective offers an analytical tool to understand inter-Korean relations before 2000.

#### ***Basic framework and legislation : 1988-1992***

The first turning point in inter-Korean economic relations after the Korean War emerged in 1972. The ROK and the DPRK authorities announced the so-called '7.4 Joint Declaration' in this year. Seoul and Pyongyang agreed in the Declaration that they would launch an economic sub-committee under the name of 'South-North Coordination Committee (SNCC)'. The SNCC was supposed to be a main vehicle to pursue a variety of cooperative projects. However, a range of disagreements between Seoul and Pyongyang surfaced in the subsequent working-level negotiations. The ROK insisted the economic sub-committee should be operated first. But the DPRK argued it should be done at the same time as the other sub-committees tackling military, diplomatic, and

cultural matters were organized. The disagreements showed the reality in which the North argued political-military (hard) issues should be handled first but the South preferred a non-political (soft) agenda as a preceding issue that needed to be resolved to deal with more substantial issues later. The ROK, in other words, attempted to make an agreement on the individually proposed functional exchange programs in the first place but the DPRK preferred a more comprehensive approach. The South's preference was for an incremental and phased approach in terms of the way of consensus building. But the North's strategy was aimed at package style agreements (Oh S.R. et al. 1995, 57-60). The two parties nevertheless reached several interim agreements in this period. Examples were how to reconcile the import/export pricing mechanism and which currency would be adopted as means of payment for anticipated interactions between the two parties (SNCC 1975). The agreements however did not imply the creation of an institutionalized body through which both parties could further promote inter-Korean economic exchanges. The two Koreas failed to form any economic agreement in the 1970s and 80s. The main cause was the existence of a wide perception gap on how to develop inter-Korean political relations in a broader context.

The Roh Tae Woo administration that took office in 1988 created a legal framework in the domestic politics for inter-Korean economic exchange. Roh Tae Woo (1988-1993) started his term with the waning of the Cold War in international politics. His administration at this juncture normalized its diplomatic relationship with the Soviet Union (September 1990) and China (August 1992) during his term. It was understood as a response to the collapse of the Cold War system in East Asian regional dynamics. The changed climate surrounding the security dynamic in the Korean Peninsula also

influenced the North Korea policy of his administration. Roh Tae Woo announced a 'Special Declaration for National Dignity, Reunification, and Prosperity' ('The 7.7 Declaration') in 1988. He proclaimed in the Declaration that the ROK government would allow South Korean people to make economic engagement with the DPRK entities (MOU 1991). The Roh administration's conciliatory attitude came from the change in post-Cold War international politics led by the United States, the ROK's key ally. The DPRK at the same time adjusted its foreign policy line in response to the disadvantageous climate after the demise of the Soviet Union and the Eastern European allies (Chun J.S. 2003, 39-44). The common efforts between the two Koreas to forge political reconciliation were made in the changed environment. The efforts resulted in signing the Agreement on Reconciliation, Non-Aggression, Exchanges, and Cooperation in 1992. The agreement created a foundation on which inter-Korean economic cooperation could burgeon.<sup>13</sup>

The Roh government made efforts to display its willingness to permit cross-border interaction between the two Koreas. The government arranged guidelines for inter-Korean economic exchanges for the first time since the end of the Korean War (Suh D.M. and Nam S.W. 2003, 246-47). This signalled that the cross-border economic exchanges between the two Koreas were likely to resume under the Roh Tae Woo administration. Any kind of exchanges between the two past enemies had strictly been prohibited until the Roh administration.

Scholars therefore agreed that the initial starting point in the history of inter-Korean economic exchange on a commercial basis was 1990. The Roh Tae Woo

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<sup>13</sup> On the details of the Basic Agreement signed in 1992, see MOU (1992).

administration enacted 'The Inter-Korean Economic Exchange Act' in this year. The government guidelines however could not in reality stimulate the ROK business actors to actually engage with the DPRK entities. The number of South Korean firms that engaged in inter-Korean trade in 1990 and 1991 was sixteen and fifty six respectively (Lee J.K. 2006, 42). These figures were less than 10% of those in the Kim Dae Jung administration which took office in 1998. In spite of the legitimization of inter-Korean trade under the Roh administration, the stagnant situation in terms of actual mutual engagement continued throughout his term.

No formal channel of dialogue between the two Koreas to discuss the modalities of the inter-Korean trade existed in the early 1990s. The only route to relate the interested parties to each other was to involve an intermediary body in a third country. Adjacent countries such as Japan, China, Singapore, and Hong Kong provided them with alternative meeting places. These indirect, or diverted, attempts for commercial transactions constituted a typical pattern of inter-Korean trade in the early 1990s (Koh H.W. 2002). This demonstrated that the longstanding political taboo between the two Koreas after the war, banning direct mutual contact, still inhibited the promotion of inter-Korean economic exchanges.

Critics, for these reasons, pointed out that the Roh administration's economic policy toward the DRPK did not create a stable foundation to enable both actors to pursue a mutual engagement strategy. They argued that the administration's policy still centered on the assumption of military confrontation with Pyongyang. Choi, for example, pointed out that the administration's new initiative was based on the strategy to alienate the DPRK by making use of the ROK's advanced economy. He construed

inter-Korean economic cooperation as a tool to further consolidate the DPRK's political isolation in post-Cold War international politics (Choi J.J. 1997, 151).

The driving force for inter-Korean economic engagement was so feeble that it could not push up subsequent economic exchanges. The weakness however did not undermine the Roh Tae Woo administration's attempt to ease inter-Korean political tension. It was true, at least, that the administration made a breakthrough in the political standoff in the Cold War dynamic in the Korean Peninsula. It was particularly the case when comparing its policy orientation with his successor, Kim Young Sam's foreign policy toward the DPRK.

#### *Nuclear crisis and issue linkage : 1993-1997*

The key words that defined the North Korea policy of the Kim Young Sam government were 'inconsistency' and 'ambivalence'.<sup>14</sup> Kim Young Sam earlier proclaimed that his administration would pursue a foreign policy focusing on national homogeneity between the two Koreas. He stressed this sympathetic approach toward Pyongyang in his inaugural speech. He stated in this speech that nothing was more important than the shared blood line in inter-Korean relations (The ROK Presidential Office 1996). Yet at the same time he revealed his hopeful expectation of the collapse of Pyongyang regime (Oberdorfer 2001, 373-74). This perception showed the opposite of his verbal remarks which were ostensibly amicable toward the DPRK.

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<sup>14</sup> For the examples and episodes showing the Kim Young Sam administration's inconsistent North Korea Policy, see Choi W.K.(1997, 199-201).

The first nuclear crisis erupted in 1993 as the DPRK announced it would withdraw from the nuclear non-proliferation regime. Kim Young Sam made a dramatic reversal in his North Korea policy following the nuclear tension. Inter-Korean relations in the early 1990s were accordingly dominated by the nuclear confrontation between the DPRK and the United States. Kim Young Sam's anti-North Korea remarks peaked against this backdrop. He revealed an ambivalent posture toward the DPRK. He stated that he would never shake hands with those who retained nuclear weapons (The ROK Presidential Office 1996).

Kim Young Sam administration's policy line toward the DPRK became increasingly tougher after the North Korean nuclear program was unveiled. By contrast, the nuclear agreement between the Clinton administration and Pyongyang heightened the mood of thaw in the Korean Peninsula. The diplomatic settlement of the nuclear crisis achieved by high-level negotiations between Washington and Pyongyang also made a breakthrough in inter-Korean relations (Wit et al. 2004). The Kim Young Sam administration announced in 1994 a set of phased measures to permit the ROK business community to resume the inter-Korean economic engagement. It was one of the responses to the change of the external foreign policy environment. The administration placed greater emphasis on large scale investment and joint venture projects with the DPRK entities. The main actors that responded to this policy change were either *chaebol* such as Daewoo and Samsung or large scale conglomerates (KIA 1995, 468-475).

The less repressive approach by Kim Young Sam to the inter-Korean economic engagement further propelled inter-Korean exchanges. They showed a remarkable increase in the mid-1990s as a result. The share of trade with the ROK in total foreign

trade of the DPRK reached 9.2% in 1995. The increase in inter-Korean trade coincided with a decrease in what they called 'concessional' trade between the PRC and the DPRK. The DPRK used to be given preferential terms of trade in 'concessional' trade between the two political allies (Huh M.Y. 1996, 57-58). The decreasing barter trade with the PRC and Russia was another problem for the DPRK as the former political allies began to require a more commercial basis transaction. The stricter pattern of trade entailed immediate hard currency payment in return for imports. But as the DPRK was unable to make cash payments, its trade volume began to plummet (Kim Y.C. 2002, 22). Inter-Korean trade played an important role to make up the deficit in the DPRK trade balance.

More striking change in trade between the two Koreas in this period was the emergence of 'processing-on-commission (POC)' based manufacturing industry in the DPRK territory. The first joint project based on this pattern of trade was undertaken in 1998. The POC generally meant one party sent raw material or parts to the other party and the receiver completed the manufacturing work by processing and assembling all the goods delivered. The sender pays for the receiver's labor in this scheme and repurchases the completed and labelled goods. The sender reaps adequate profits by selling them either in the domestic or the foreign market (MOU 2007, 42).

The policy reversal of the ROK government to permit production in the DPRK stimulated ROK industry. ROK firms such as Daewoo and Gohap sought government approval in 1995 for projects to manufacture their goods in the major cities in the DPRK. The ROK government accepted their offer. The new policy initiative enabled the ROK firms to utilize the North Korean workforce on site. They were supposed to churn

out products with the South Korean brand (Kim Y.C. et al. 2002, 24-25). The operation of the production facilities in the DPRK implied that ROK firms no longer needed to contact their Northern neighbor through an intermediary. The processing-on-commission manufacture laid the foundation for deeper direct interdependence between the two Koreas. POC trade required more frequent human exchanges and a longer-term pre-contact before launching their joint business. This further buttressed interdependence between the South and the North.

However, three points should be critically evaluated in viewing the inter-Korean trade under the Kim Young Sam administration despite the quantitative increase in inter-Korean trade. Firstly, Kim Young Sam regarded inter-Korean trade as one of the solutions to make up for the shortage of North Korean economic resources in the mid-1990s. Such a conceptualization of inter-Korean trade lacked proper understanding of commercial transactions as mutually beneficial economic exchange. This poorly defined role for the inter-Korean trade produced unrealistic policy recommendations for the ROK government. They included policy prescriptions such as support for the DPRK's accession to the International Monetary Fund (IMF) and the pursuit of a South-North free trade agreement (Huh M.Y.1996, 90-92). Before long when the IMF / World Bank fact-finding mission team visited Pyongyang, it became clear that Pyongyang had absolutely no preparation to cooperate with the international financial organizations, which required substantial information sharing with them (Harrison 2002, 35-36).

Secondly, the Kim Young Sam administration subordinated inter-Korean economic interactions to the insecurity caused by nuclear crisis. The security concern was heavily affected by the U.S.-DPRK nuclear confrontation. The administration

maintained an intransigent posture against the Clinton administration's efforts for diplomatic dialogue with Pyongyang to tranquilize the nuclear crisis. Direct engagement by the South government was largely confined within the realm of division of responsibility about how to denuclearize the DPRK. As a result, there were no more than 15 inter-Korean direct dialogues undertaken in the Kim Young Sam administration (1993-1997). This was much less than those under his predecessor Roh Tae Woo (1989-1993, 82 times), who managed the inter-Korean relations immediately after the demise of the Cold War (Choi, W.K.1997). A purpose of Kim Young Sam's attempts to link inter-Korean economic relations to the nuclear crisis was to acquire diplomatic leverage, by economically engaging with the DPRK, to press the Pyongyang regime to dismantle its nuclear program. But this strategy was unsuccessful. The strategy ended up losing the opportunity to create a strengthened interdependence between the two Koreas. He made the increasing inter-Korean economic interdependence subordinate to the hostile coexistence between the two Koreas. It consolidated at the same time the ROK entrepreneurs' perception that their investment in the DPRK would be fragile unless military tension ended in the Korean Peninsula.

Thirdly, Kim Young Sam did not acknowledge the non-state level contact with DPRK entities. A momentum for direct humanitarian engagement came when the DPRK underwent nationwide famine in the mid-1990s after the two great floods. The Kim Young Sam administration however did not allow any involvement of non-governmental, humanitarian groups in the food aid being discussed toward the North Korean population. The administration instead insisted on the need for a 'phased and orderly' approach in sending relief material to the DPRK, which meant dismissing a

good deal of requests for contact with North Korean counterparts made from South Korean non-governmental organizations, with the only exception of the Korean Red Cross. Since the North already made clear that they would not accept any food aid through 'government *vis-à-vis* government' channels from the South, a serious impasse was unavoidable even in delivering the 150,000 tons of rice the Kim Young Sam regime had already pledged (*Dong-A Ilbo*, June 22<sup>th</sup>, 1995). Critics pointed out that Kim Young Sam's firm attitude of not allowing more efficient aid channel both in domestic and international arenas reflected his intention of hoping to monopolize any accomplishment and parade it in inter-Korean matters (Choi W.K. 1997). Kim Young Sam had a belief that inter-Korean bargaining even over the humanitarian aid issue could and should be undertaken on the basis of acknowledging the sovereign authority of each party. The emphasis on sovereign authority in his foreign policy, as supreme and unitary negotiating power, was deepened as a result of the crisis of national security caused by the nuclear crisis in the 1990s.

When comparing the Kim Young Sam administration's policy line with his predecessors, it showed a regressive approach when it came to the inter-Korean economic interactions. Roh Tae Woo's foreign policy could be assessed that he took advantage of the demise of the Cold War and the disintegration of the communist bloc. Kim Young Sam however underestimated the pattern of change in international politics which signalled the emergence of new actors and dynamics.

### *Lack of political consideration*

Despite several points that showed the difference between Roh Tae Woo and Kim Young Sam, both administrations exposed similar pattern of limitations in that their policy failed to appreciate the extent to which economic cooperation could further political dimensions of inter-Korean relations. As Yoon pointed out, inter-Korean economic cooperation had a potential to be developed into a main axis which could resolve more comprehensive issues that the two Koreas had been facing (Yoon Y.K. 2003). Inter-Korean economic cooperation should have been considered, in other words, not only as a tool to seek economic benefit based on the comparative advantage logic. Rather it should have been treated as an instrumental method which could bring about political reconfiguration in the Korean Peninsula.

The Roh Tae Woo and the Kim Young Sam administrations showed limitations on how to relate the political and the economic interactions between the two Koreas. The new pattern of joint manufacturing system by the POC offered an opportunity to institutionalize the inter-Korean economic exchange programs. Both administrations however failed to use this opportunity to create an institutionalized environment for the sustainable development of the inter-Korean trade.

Three factors should be pointed out to explain this failure. Firstly, the administrations failed to capture the role of transnational interaction in the inter-Korean relations in the 1990s. Keohane and Nye defined transnational interaction as ‘a movement of items across the state boundaries when at least one actor is not an agent of a government or an intergovernmental organization’ (Keohane and Nye 1972, ix-xii).

Neither administration however allowed any kind of mutual engagement outside intergovernmental contacts. The then ROK government defined itself as the planner and enforcer of all kinds of economic interactions between the two Koreas. South Korean firms, the actual players in the inter-Korean trade, remained in a secondary role.

Secondly, the two administrations underestimated the participation of the SMEs in promoting inter-Korean trade relations. The significance of SMEs in inter-Korean trade was convincing on two points. The greater business actors' engagement was likely to stabilize and institutionalize inter-Korean economic exchange. One success story at the same time was likely to attract a number of SMEs by providing them with alternative production sites replacing China or Vietnam. The administrations however did not provide sufficient incentives for South Korean SMEs that had substantial economic interests in inter-Korean trade.

Thirdly, their tough posture demanding rigid reciprocity remained unchanged in terms of the correlation between the political environment and the economic interactions. The demand for reciprocity by the South in inter-Korean negotiations worked relatively well in the Roh Tae Woo administration. One of the reasons was because the DPRK showed a more accommodative attitude in debatable issues between the two Koreas. The issues included the joint accession to the United Nations and the signing of the Basic Agreement with the ROK (Song M.H. 2008).<sup>15</sup> This attitude change came from the fact that the North felt a disadvantaged climate in regional politics as the former North Korean allies, upon which Pyongyang heavily relied for oil supply, lost their power. Under the Kim Young Sam administration however the requirement of

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<sup>15</sup> The DPRK had not agreed to the UN joint accession for the reason that it would perpetuate the national division in the Korean Peninsula until it changed the position in the early 1990s.

rigid reciprocity faced an obstacle. The Clinton administration, unlike Kim Young Sam, exploited direct dialogue with Pyongyang and rewarded its diplomatic course of actions to dismantle the nuclear program. As a result the ROK government that kept insisting on rigid reciprocity was sidelined in the negotiations (Choi W.K. 1997, 203-4).

All these three factors meant that the two governments failed to realize the complex nature of inter-Korean economic exchanges. They did not pay attention to how the inter-Korean economic exchanges should relate to the political future of the two Koreas. They were not prepared to grasp the fact that the inter-Korean economic exchanges were not incompatible with each other's clashing political interests. The lack of perception on this intertwined nature of the inter-Korean economic and political interaction caused a lack of policy continuity. The implementation of the government level economic agreement was paralyzed whenever there was mounting military tension in the Peninsula. The main concern about inter-Korean economic exchange in the next government therefore became how to insulate inter-Korean trade from political turbulence.

### *Theoretical interpretation*

In the 1990s, despite a set of agreements to defuse the likelihood of a military clash in the Korean peninsula (Jeong S.H. 1992, Lee G. 2005), inter-Korean relations could be better explained in essence by the realist perspective. A shared assumption of realism was, although it was not monolithic, the conflictual nature of international politics. Realist thinking also required the primacy of power and security in political life

(Gilpin 1986, 304-5). Classical realists believed that the most powerful actors in international politics are those with the greatest military strength (Morgenthau 1985, 29).

Emphasis on national security by defensive realists in particular provided Korea analysts with useful guidance in understanding inter-Korean cooperation and conflict in the 1990s. The defensive realists identified the ultimate goal of states as their pursuit of security rather than maximizing and expanding their power (Waltz 1989, 40). Power maximizing behavior of states the classical realists assumed, according to the defensive realists, did not come from universal attributes of states but come from states' particular ambitions that aimed to become a global hegemon (Snyder 1991, 10-13). Power maximizing theory had significant flaws when attempting to predict a weak state's behaviour such as the DPRK.

When it came to interactions between states, the 'zero-sum' nature of international politics was still useful for neorealists. According to the neorealists, so long as each actor fears how the other will use its increased capabilities, interstate cooperation is highly unlikely. Despite the existence of a range of institutions as well as internationally cooperative organizations, 'self-help' was the only means to guarantee the survival of states (Waltz 1979, 105-111).<sup>16</sup> Only limited cooperation was possible in neorealist thinking where a state stands to gain more than other states. Grieco (1988), for example, had warned of the danger of a weak state's 'unilateral act' that could be triggered when

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<sup>16</sup> The definition of an institution in this chapter follows that of Keohane et al.(1993, 4-5). It therefore includes agreements and treaties between states, which bind their behavior toward each other, as well as organizations and bureaucratic agencies.

realizing its 'relative loss'. Based mainly on this argument, he dismissed the possibility of interstate cooperation under the anarchical situation.

Inter-Korean relations in the 1990s were understood in accordance with the logic of neorealist tradition, that is, security/military-dominated issue areas. Security fears that came from the increasingly asymmetrical military balance between the two Koreas made the DPRK leadership take a more unyielding attitude in its military line (Kang 2003). Under this situation, taking advantage of the other's weakness was regarded by both sides as the most appropriate policy option to achieve their goals. Diplomatic dialogue or cooperative behavior was underestimated. Both parties perceived, if at all, that the intermittent dialogues and negotiations were continued efforts to 'manage' conflict or to maintain 'conflictive', not 'peaceful' coexistence (Huh M.Y. 2006, 199).

Before the Kim Dae Jung administration, it was not easy to discover scholarly attempts in which the DPRK was analyzed as a cooperative partner in foreign affairs. The DPRK was still the object of countering and confrontation. The analysis of North Korean foreign policy behavior did not fit well into the interdependence model developed by the neoliberals. As the nuclear confrontation in the 1990s implied, most scholarly works in international relations focused on the DPRK's non-compliance with the nuclear non-proliferation regime and its unilateral acts (Lee C.K. 1995, Wit et al. 2004). The DPRK's position on the nuclear issues in the 1990s, on the contrary, showed that the DPRK leadership regarded the nuclear disarmament deal as an issue of political survival. This also meant that Pyongyang perceived that any kind of denuclearization attempts by external powers would incur relative loss in US-DPRK relations. Pyongyang viewed the relative gains obtained either by Washington or by Seoul as a

threat to its own survival. There was little evidence, on the other hand, that any political institutions between South and North Korea contributed to create their sustainable reciprocal relationship. Several inter-Korean political agreements were successfully made in the early 1990s. They were built on both parties' consensus to end antagonism and to ensure peaceful coexistence. But they were fragile when it came to the implementation plans. They were insufficient to ease each other's suspicion of military provocation by the other side (Lee G. 2005).

For more than a decade after the Roh Tae Woo government legitimized inter-Korean trade, economic issues in inter-Korean relations were largely overshadowed due to the destabilized security environment. As shown in the nuclear deal in the 1990s, escalation of tension in the security area seriously hampered the progress of economic interdependence between the two Koreas. Thus analytical insight built upon political realism was dominantly required to interpret the ROK government's North Korea policy in the 1990s. The influential power of state actors was the only and legitimized avenue of inter-Korean negotiations and no alternative contact channel was allowed either to complement or to replace inter-governmental channels. Functionalist theorization that paid attention to the role of specified economic exchanges in dismantling a situation of military tension (Mitrany 1969) was dismissed. As realists earlier formulated it, the role of international institutions in the inter-Korean relations was marginal in this period (Waltz 1979, 115-116).

The security concern in inter-Korean relations was the more pivotal factor in the DPRK foreign policy. From the North Korean point of view, unrelenting struggle for survival upheld by strong sovereign power was even more crucial in the 1990s. As its

national slogan known as 'arduous marching', which was rampant during the famine, implied, the need of a strong system for mobilization of resources and workers based on state authority was indispensable to avoid a likely collapse of its socioeconomic system. As a response to the implosion of the old Soviet Union and Eastern Europe, the North promulgated 'socialism of our style' to overcome its legitimization crisis (Armstrong 1997). Priority in the DPRK foreign policy was securing capability for nuclear deterrence against the United States and building up political power not to become embroiled in the move for 'reunification by absorption', which would mean extinction of the Kim Jong Il regime. To the North Korean leadership, nuclear disarming, especially by means of conciliatory and cooperative action with the South, meant abandoning the most effective tool for survival against external threats which hoped for the collapse of the regime. The argument of defensive realists that a state seeks the requisite amount of power to ensure its own survival, not domination of other states, offers a reasonable tool for explaining the DPRK's nuclear ambition (Grieco 1997). To the DPRK in the 1990s, maintaining conditions for the balance of power in the Peninsula was a primary objective and efforts to pursue 'self-help' were the most important means to achieve it. Smith pointed out that the DPRK foreign policy showed a shift from classical revolutionism to political realism (Smith 1997, 109-110). Mutual gains, balance of power through an international system, and limited exercise of state sovereignty for an integrated community etc., stressed by neoliberal international relations scholars, were not on the DPRK's foreign policy agenda at all during this period.

The only exception to such bilateral statism-led inter-Korean relations in the 1990s was the proposal for a four-power conference jointly announced by Kim Young Sam and the U.S. President Bill Clinton in April 1996. After the U.S.-ROK summit held that year, they proposed the conference by inviting China and the DPRK 'to initiate a process aimed at achieving a permanent peace agreement'. As far as international relations theory is concerned, it could be interpreted as an attempt to create 'a regional peace regime' which had been preferred by many scholars as an efficient vehicle to facilitate cooperation between states (Ruggie 1975, Krasner 1983, Keohane 1989). The proposal for the four-party conference, emerged two years after the successful agreement in the nuclear talks in 1994, could be viewed as the first attempt to establish a cooperative institution to discuss how to initiate the peace-building process in the denuclearized Korean Peninsula. It further heightened the expectation for a new peace treaty in the Korean Peninsula to replace the 1953 armistice.

However, the proposal did not see any fruitful outcome not only within Kim Young Sam era but even under the next administration led by Kim Dae Jung who leaned toward neoliberal prescriptions in the North Korea policy establishment. After repeated briefings demanded by Pyongyang and the several preliminary talks over agendas and dates, the first meeting in which all four members on board was held in Geneva in December 1997. But 17 months had already passed since the proposal was initially made in 1996 and it was immediately before Kim Young Sam left office. With continued standoffs and impasses between the parties, the conference finally came to an end in 1999 without any visible progress on the declared peace regime building.

Three misguided North Korea policies by Kim Young Sam could be pointed out to explain this failure of building up a cooperative regime in the Northeast Asia. Firstly, the two Koreas envisioned a different objective to be achieved through the four-party talks. While the South argued transition from armistice status to that of a permanent peace arrangement, the North revealed its indifference to the proposed multilateral peace regime. Withdrawal of the US army from the ROK territory and the bilateral peace arrangement between the DPRK and the United States were the primary issues Pyongyang wanted to deal with in the talks (Shin S.J.1998). Secondly, whether rice aid toward the North Korean population should be delivered created a hurdle blocking advancement of the talks. While the DPRK insisted that without a guarantee of rice aid from the ROK they were not willing to consider its participation in the four-party conference, the Kim Young Sam administration made clear it had no intention to send the North relief rice for the purpose of bringing Pyongyang to the negotiation table. Kim further persuaded Washington not to give Pyongyang relief aid as a reward for seating on the negotiation table (*Dong-A Ilbo* 30<sup>th</sup> March 1997). He also prohibited South Korean civil organizations from contacting North Korean people to discuss the rice aid issue even though there were a number of requests by the South Korean humanitarian agencies. He disliked any kind of non-governmental level (track II) diplomacy between Seoul and Pyongyang, which previously had defused the nuclear crisis when the U.S. former president Jimmy Carter met Kim Il Sung in 1994 on the verge of military clash (Oberdorfer 2001, 326-36). Thirdly and more importantly, Kim Young Sam was seriously doubtful about cooperating with Pyongyang. He was keen to show Pyongyang

a firm lead in inter-Korean relations and was reluctant to be a participant in a multilateral institution in which the ROK's leadership was limited. The idea of a four-party conference was originally proposed not by Seoul but by Washington. The agreement of Kim Young Sam to the initiative of the conference was his reluctant response to the Clinton team's pressure requiring more substantive moves toward peace building in the Korean Peninsula as a precondition for the summit talks proposed by Kim, toward which Washington had previously maintained a lukewarm attitude. Kim was so eager to take advantage of the summit in view of the imminent general election that he accepted the U.S. request in an attempt to produce surprising news before the election (Oberdorfer 2001, 382-87).

The abortive four-party conference proved that the effort to establish a multilateral institution in the Peninsula in the 1990s was no more than an attempt to strengthen the statecraft of the South government. Such an episode offers grounds for realists' arguments that an institution can be established only if states seek the goals that the institution will help them reach (Jervis 1999, 54). All in all, the realists' perspective arguing cooperation through institutions between rival nations was improbable offered a useful guide to understand the inter-Korean relations under the Kim Young Sam administration. His North Korea policy resulted in the dominance of statism in the Korean Peninsula.

## ***2.4 Conclusion***

This chapter examined the background of American rhetoric that portrayed the DPRK as one of the 'rogue states' under the Clinton administration. The chapter

concluded that the applicability of this rhetoric to the case of the inter-Korean relations was not considerable. However, the attempts to label Pyongyang as an evil power illustrated that the key nature of the relationship between the DPRK and the surrounding powers in the 1990s. This relationship based on highly state-centric military dynamics could be explained by the typical realism model in IR theories. The foreign policy in dealing with the DPRK was still dominated by strict issue hierarchy centered on nuclear disarmament. The intergovernmental channel between Foreign Affairs Department of Washington and Pyongyang was the only route on which their interactions relied. There was no sign, if not evidence, that military confrontation between the United States and the DPRK lost the position as the foremost negotiation issue. This relationship was also true when it came to inter-Korean relations before 2000. The security concern was a dominant factor defining the relations outweighing other issue areas like economic cooperation. Inter-Korean contact channels at the subnational level were not permitted under the Kim Young Sam administration. The Kim administration's hard line attitude toward Pyongyang as a result consolidated the features of inter-Korean relations characterized by political realism.

## CHAPTER 3

### Inter-Korean relations after 2000

#### ***3.1. Introduction***

This chapter will argue that the exchanges and cooperation projects implemented as a result of the Inter-Korean Joint Declaration in 2000 undermined the state/military-centric foundation of the inter-Korean relations since the 1980s. The chapter will demonstrate how this changed security environment in the Korean Peninsula engendered new actors and issues in inter-Korean interactions with exploring the development of the inter-Korean relations under the Kim Dae Jung (1998-2002) and Roh Moo Hyun (2002-2007) leaderships. The chapter will argue that the viewpoint of political realism, which had dominated the interpretation of inter-Korean relations since the Korean War, no longer provided an appropriate perspective as an analytical tool in the wake of the new development of various non-security issues and actors after 2000. It will then propose the complex interdependence model, formulated by Keohane and Nye, as a new analytical framework to interpret this substantial change.

#### ***3.2 U.S.-DPRK relations under the Bush administration 2000-2002***

This section will explore two main points. Firstly, it will investigate the background that generated the Bush administration's 'war on terrorism' and 'axis of evil'

discourse. This will demonstrate that, in global terms, the Bush administration's anti-terrorism strategy further consolidated its perception of the DPRK constituting an international terrorist group. Secondly, it will analyze how President Bush viewed and described the DPRK. His remarks will contrast with the DPRK's attempts to resume engagement with its Northeast Asian counterparts such as the ROK and Japan. This tense relationship between Washington and Pyongyang will offer one causal variable in the 2002 nuclear crisis that will be elaborated in chapter 4.

*'War on terrorism' and 'Axis of evil'*

The Bush administration took office in January 2001 and announced the outcome of its policy review toward the DPRK in June of the same year. President Bush stated that he was determined that 'serious discussions' on a 'broad agenda' should be resumed with Pyongyang. Bush was believed to register his desire to conduct 'comprehensive' negotiations including 'improved implementation' without any precondition (Niksich 2002). It was also believed, at least at this point, that a part of the new administration's foreign policy team had an intention to handle North Korean issues by diplomatic dialogue rather than armed deterrence.<sup>17</sup>

However, the terrorist attack on the New York Trade Towers in September 2001 drastically reinforced the U.S. stance against any kind of nuclear proliferation attempts. Rhetoric by high ranking officials in the Administration spelled out a more intransigent

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<sup>17</sup> Intensive debates on how to deal with the DPRK were conducted within the Department of State and later resulted in retreat of the officials that had preferred a resumption of dialogue and negotiation opposing a coercive approach. For more illuminating anecdotes, see Quinones (2003) and Pritchard (2007).

approach against the rogue states identified by the Clinton administration. Bush's Defence Secretary, Donald Rumsfeld (2002, 21) proclaimed, in response to the terrorist attack, the arrival of 'new ways of thinking and new ways of fighting' in waging its foreign policy. Stephen Walt (2001/2, 56) also heralded 'the most rapid and dramatic change in the history of U.S. foreign policy' immediately after the September 11 terrorist attack.

The United States Congress passed its joint resolution, a week after the attack, authorizing the use of United States armed forces against those responsible for the attack (U.S. Congress 2001). The resolution offered a momentum to the term 'war on terrorism' and gained widespread currency within academia as well as in foreign policy. The rogue state discourse that had dominated the U.S. foreign policy in the previous administration acquired supplementary logic through the term 'war on terrorism'. After the emergence of the term 'war on terrorism', the U.S. government literature (Bush 2002b) began to link the idea of terrorism with the notion of the rogue states.

In the State of the Union address in January 2002, President Bush also designated the DPRK as a member of the 'axis of evil' (Bush 2002a). State-centric analyses of the Korean security environment built upon the likelihood of ensuing military conflict identified the DPRK along with Iraq and Iran in the 'axis of evil'. These made the nuclear issue within the Korean Peninsula broader and more complex. Documentary evidence in Afghanistan that al Qaeda sought WMDs, including nuclear weapons, also influenced the Bush administration to broaden the definition of the war against terrorism. President Bush regarded states like the DPRK as a potential supplier of WMDs to al Qaeda (Niksich 2002).

Critics of the 'axis of evil' language regarded the inclusion of the DPRK within its framework with suspicion. They argued that its inclusion diluted the expected antipathy from the Islamic community that might be derived from linking Islamic states such as Iran and Iraq under the same banner of the 'axis of evil' (Applebaum 2002). This was particularly so given the fact that the animosity from Islamic nations had been fuelled when the majority of states under the rogue states rubric turned out to be Islamic (Litwak 2000, 8).

The addition of the DPRK within the 'axis of evil' thereby located this potentially dangerous player in the Bush administration's global anti-terrorist strategy. This made the implementation of the 1994 Agreed Framework more difficult. The U.S. Department of Defence released its 'Nuclear Posture Review' in January 2002. The Bush administration in this review adopted a more aggressive line toward potential proliferators. The basis of American nuclear strategy shifted from a long standing nuclear rivalry with another superpower to unstable relationships with 'rogue state proliferators' (Preez 2002, Payne 2005, McDonough 2006). This implied the DPRK issue would also be dealt with under the strategy countering international terrorist groups. They did not take into account the fact that the DPRK was not involved in any terrorist attack after the 1980s (Smith 2005a, 48-49). Bush's new strategy aiming to introduce as strong a containment policy toward the DPRK as that against Saddam Hussein has been criticized in that he failed to appreciate the great difference between Pyongyang and Iraq (O'Hanlon 2002).

### *Prelude to another crisis*

The facilitator that broke the stalemate between the DPRK and the United States was the ROK government. President Kim Dae Jung dispatched Lim Dong Won as a special envoy to the DPRK three months after Bush's 'axis of evil' remarks. Lim Dong Won was one of the key architects of the 'Sunshine Policy' who had accompanied the president at the Pyongyang summit in 2000. Lim Dong Won arranged a joint announcement between the two Korean authorities pledging resumption of inter-Korean cooperative projects that had already been agreed. They included the inter-Korean railways link and the revitalization of the Mount Kumkang tourism project. The Lim Dong Won - Kim Jong Il meeting in Pyongyang also contributed to the subsequent change in Washington's attitude toward Pyongyang (*New York Times* 6<sup>th</sup> April 2002).

The DPRK leadership at the same time resumed high level talks with Japan to normalize their diplomatic relationship. Pyongyang admitted in the middle of the talks that they had abducted Japanese citizens in the 1970s and 80s. It also allowed the surviving abductees to visit their home country. The resumption of the dialogue between the DPRK and Japan led to the summit of Kim Jong Il and Junichiro Koizumi, the Japanese Prime Minister, in September 2002 (Rozman 2002). The DPRK leadership, moreover, decided to send more than 600 participants and representatives to join the Asian Games held in Pusan in September 2002. This also marked the North's first-ever participation in an international sporting event in the South (Laney and Shaplen 2003).

All these events occurred simultaneously one or two months before the eruption of the second nuclear crisis in 2002, signalling a decreased hostility of Pyongyang toward

the external powers. It was the first time that the DPRK participated in this brief détente (Lee J.H. and Moon C.I. 2003, 136). North Korea tried to actively engage with all three nations at this time, the United States, Japan and the ROK (Laney and Shaplen 2003, 17). Kim Jong Il, most of all, demonstrated sufficient interest in engaging with the outside world, evidence for which was the creation of special economic zones and the limited liberalization of commodity prices (O'Hanlon and Mochizuki 2003, 12).

Bush, in the meantime, expressed his personal abhorrence toward Kim Jong Il in a non-diplomatic manner. This did not help the mood of reconciliation in the Northeast Asian region. Bob Woodward quoted, for example, that President Bush stated "I loathe Kim Jong Il, I've got a visceral reaction to this guy because he is starving his people." (Woodward 2002, 340). Literature on U.S. foreign policy began to reinterpret the term 'engagement' under which the Clinton administration pursued the 1994 Agreed Framework. Victor Cha argued that the term 'engagement' should be understood as a way to strengthen the inter-state, exclusive alliance in the U.S, the ROK, and Japan triangle (Cha 2002). This argument attracted the attention of the Bush administration that had been seeking further punitive actions against the DPRK. Despite the engagement signal from Pyongyang, Washington's neglect of the Kim Jong Il regime escalated the tense relationship in the Korean Peninsula.

### ***3.3 Inter-Korean relations under the Kim Dae Jung administration (1997-2002)***

This section will show how the Kim Dae Jung administration strove to continue to pursue engagement attempts with the DPRK despite Pyongyang's growing confrontation with Washington. The section will particularly stress a crucial role that the

so-called '*Jongkyong Bulli*' principle and 'multiple channel policy' by Kim Dae Jung played in making the coexistence of economic cooperation and political confrontation possible. It will then highlight the two policy initiatives by which Kim Dae Jung engendered deregulation of South Korean firms' investment in the DPRK. After critically reviewing the existing attempts to formulate the relationship of security and economic interdependence, this section will conclude that the complex interdependence model offered an analytical insight in understanding Kim Dae Jung's 'Sunshine Policy' and its key initiatives.

#### *'Axis of evil' and 'Sunshine Policy'*

The reconciliation mood in the Korean Peninsula created by the first-ever inter-Korean summit was significantly overshadowed by Bush's 'axis of evil' remark. The simmering U.S.-DPRK relationship under the Bush administration created an apparent obstacle in further developing inter-Korean relations. The Kim Dae Jung administration were concerned that Bush's remark toward Pyongyang was too provocative and unnecessary. China and Japan were equally concerned that the U.S. strategy might cause a second Korean War although they shared Bush's determination for a nuclear disarmed North Korea. Nevertheless, armed confrontation was likely to be inevitable given the strong animosity of Bush's foreign policy team toward Pyongyang. Some observers depicted such a situation as an 'incompatible marriage of sunshine and axis of evil' (*Washington Post* 16<sup>th</sup> February 2002).

The Kim Dae Jung administration's endeavor to sustain a driving force of the planned progress of inter-Korean relation after the 2000 summit was made in two dimensions. Firstly, the administration employed a direct persuasion strategy to Washington by engineering Kim's early visit to the White House before Bush's foreign policy team concluded their policy review on the DPRK. But Kim Dae Jung returned home empty handed failing to win Bush's public affirmation of support of his 'Sunshine Policy' toward the DPRK. Bush was not reluctant at all in revealing his skepticism on the North Korean leader and the future of its regime. This hasty attempt for the summit talks in the White House resulted in widening the gap between Seoul and Washington (Quinones 2003). The Kim Dae Jung administration however managed to neutralize Washington's stiff attitude during the second summit held in Seoul in February 2002. As a result of Kim Dae Jung's efforts to mitigate the growing tension in the Korean Peninsula after Bush's 'axis of evil' remark, President Bush in this summit confirmed that he had no intention either to attack or to invade the DPRK. By engineering the reiteration of the two presidents on the importance of diplomatic dialogue in resolving the growing U.S.-DPRK confrontation, Seoul created a momentum to deter Washington's aggressive line likely to hinder the progress of inter-Korean relations since the new Republican government took power (Lim D.W.2008, 582-604). Secondly, Seoul embarked on more direct contact with Pyongyang to restore halted inter-Korean cooperative projects by dispatching the President's special envoy. Lim Dong Won, one of the top aides for the president and former chief of the National Intelligence Service, visited Pyongyang amid the growing tension triggered by the 'axis of evil' remark. He hammered out a joint communiqué with his North Korean counterpart after more than 2

hours of talks with Kim Jong Il to discuss conditions to resume inter-Korean joint projects proposed in the 2000 summit. Both parties agreed to resume the joint projects such as inter-Korean railway reconnection and family reunion events as well as the resumption of military talks between the South and the North. Lim's successful visit to Pyongyang offered a critical moment that enabled the Kim Dae Jung administration to consistently push forward his pro-engagement policy toward Pyongyang which had once been snubbed by its key ally in Washington. As a consequence, Kim Dae Jung was able to grasp an opportunity to realize his lifelong initiative to forge inter-Korean reconciliation through economic cooperation (Lim D.W. 2008, 592-620).

### *'Jongkyong Bulli'*

The key guideline that constituted the foreign economic policy toward the DPRK by the Kim Dae Jung administration was the principle of so-called '*Jongkyong Bulli*'. The principle was proclaimed in Kim Dae Jung's inaugural speech as one of the key tenets of his 'Sunshine Policy' (MOU 2003). This meant, by definition, the separation of politics and economy. It implied, as a policy dealing with a hostile nation, that cross-border economic activities should consistently be carried out regardless of, and in spite of, political confrontation.

His '*Jongkyong Bulli*' initiative was a great challenge to the conventional formulation of issue linkage as a foreign policy tool under asymmetrical international relations. As Mastanduno (1998) argued, stronger nations in the post-Cold War international politics tended to link security and economy issues to preserve their

hegemonic standing. As the predominance of security concern faded out along with the collapse of the bipolar Cold War structure, the growing significance of economic interests opened a greater room in which the stronger nation can acquire more powerful bargaining leverage than before. The stronger nation could expand its security influence by providing a *quid pro quo* to more or less fulfil the weaker nation's economic requirement. Issue linkage in this respect was one of the most useful vehicles for a stronger nation in discharging foreign policy to easily adopt in an effort to consolidate its preponderance.<sup>18</sup>

In contrast, Kim Dae Jung's pursuit of separation of security and economy was an effort to overcome the previous attempts, particularly under the Kim Young Sam administration, which had maintained strong linkage tactics in dealing with the DPRK. Kim Dae Jung rather made every effort to diminish the likely ramification of the two Koreas' widening gap both in economic and military capability which might force the Kim Jong Il regime to deepen its isolation for fear of possible extinction or absorption by external power (Kim D.J. 2004).

Taking this backdrop into account, the principle of '*Jongkyong Bulli*' can accordingly be defined as follows. Firstly, inter-Korean political and military issues should not be directly linked with economic exchange and cooperation between two parties. Secondly, government regulation of the South Korean firms to inhibit the free flow of the inter-Korean exchange of goods should be mitigated. Thirdly, inter-Korean

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<sup>18</sup> On the other hand, it is also worth noting that the earlier proponents of 'issue-linkage' tended to shed more light on the linkage attempts and its consequences by weaker actors or outsiders to put their own concern into the existing negotiation frame shaped by advanced players. This suggested the linkage attempt by stronger actor was not necessarily the only efficient way to guarantee their victory in the whole cluster of interests. See Branislav and Ruggie (1979) and Haas (1980).

economic cooperation should be pursued on the basis of non-governmental actors' own interests and commercial considerations (Kim Y.Y. 2005).

The pursuit of '*Jongkyong Bulli*' implied a more permanent approach for the sustainability of inter-Korean relations. It did so in that the policy was unlikely to be affected by unpredictable change in the political environment. The '*Jongkyong Bulli*' principle, based on the thinking of 'give first, take later', substantially eschewed the tight issue-linkage attempts especially by the Kim Young Sam administration. It was highly contrary to the previous administration's logic on inter-Korean economic engagement, which was 'no dismantlement of nuclear weapons, no economic aid at any levels'. The new administration was not unduly obsessed with the purpose of creating a rigidly reciprocal relationship between the South and the North. It rather opened a wider way to strengthen inter-Korean interdependence even under political deadlock. Even if the chosen project was likely to politically benefit the DPRK regime, the administration did not put it aside for the anticipated advantage of the DPRK. The project would continue as long as it resulted in constructive contribution to the promotion of inter-Korean economic engagement. The ROK business community could make its own judgement on inter-Korean trade with the help of the '*Jongkyong Bulli*' policy as a result. The policy helped sustain inter-Korean trade from the influence of the unpredictable political situation. Political scientists, furthermore, forecasted a longer term contribution of the '*Jongkyong Bulli*' to the reunification policy of the ROK government. They envisioned a circular structure such as the progress of inter-Korean economic cooperation → wider trust building → reduction of defence cost → reduction of reunification cost (Lee J.S. 1998, 11).

By consistently pursuing the '*Jongkyong Bulli*' principle, the Kim Dae Jung administration sent the DPRK consistent and repeated messages. They implied that if Pyongyang opened the door to South Korean economic engagement endeavor at both governmental and non-governmental levels it would lay a firm foundation to revive its economy. The Kim administration indicated that the benefit would not only come from an economic aid program but also from a wider security guarantee for the DPRK. But the administration pursued it not by urging political transformation of the Kim Jong Il regime but by letting it have sufficient motives by which the North could initiate its own program for economic openness. In this sense, Kim Dae Jung did not exploit a firm linkage politics with the purpose of gaining Pareto-optimal benefits from inter-Korean negotiations. He rather believed that an improvement in the position of the weaker party as a result of negotiations could forge more desirable inter-Korean economic relations in the long run. The belief laid the foundation for the development of inter-Korean trade even under political turbulence.

The implementation of the '*Jongkyong Bulli*' principle also made a contribution to deterring further development of the North Korean nuclear crisis. Kim Dae Jung's attempts to safely manage the inter-Korean relations by employing economic leverage made a contribution to preventing small scale conflict from developing into a serious clash. For instance, inter-Korean ministerial talks arranged as a follow-up step to implement the details of the joint declaration of the Kim Dae Jung – Kim Jong Il summit proved to be a useful channel in which the South persuaded or urged the North to respond to the six-party denuclearization talks. The two Koreas agreed to cooperate with each other for the peaceful resolution of military conflict through 9 rounds of inter-

Korean ministerial talks under the Kim Dae Jung administration. As James Kelly, the head of the U.S. delegation of denuclearization talks, commented, inter-Korean ministerial talks strongly backed the resolution of North Korean nuclear issue (*Hankyoreh* 3<sup>rd</sup> February 2004). A further nuclear crisis did not erupt until the DPRK admitted its uranium-based nuclear enrichment program just before Kim Dae Jung left office.

### *Permission for multiple channels*

The policy initiative, coupled with '*Jongkyong Bulli*', that encouraged inter-Korean trade was what Kim Dae Jung called the 'multiple channel policy'. His predecessor, Kim Young Sam had either banned or rigidly screened inter-Korean exchanges at the non-governmental level (Choi W. K. 1997). Kim Dae Jung, on the contrary, permitted civic groups and businessmen to get in touch with the DPRK entities with minimum guidelines. Kim Dae Jung announced in February 1999 that he would permit South Korean civic groups and NGOs to contact North Korean individuals and organizations for the purpose of humanitarian aid. His new initiative showed a sharp contrast to Kim Young Sam's policy. Kim Young Sam had banned even fund raising campaigns by South Korean NGOs to assist the food shortage in the DPRK. The Korean Red Cross was the only exception in his prohibition of campaigns by non-governmental agencies (Lee K.S. 2000, 9-34).

The DPRK's response to the ROK government's policy change was positive. The DPRK had been proposing, until the mid-1990s, large scale North-South conferences.

Pyongyang had insisted on proposing the conferences where ROK representation should include not only government officials but a wide variety of citizen groups. The citizen groups in Pyongyang's statement in effect referred to ones sympathetic or neutral toward themselves (Harrison 2002, 95). The DPRK accepted Kim Dae Jung's 'multiple channel policy' in this vein as a desirable response to its consistent position. It assessed the policy as a way to create a breakthrough in the stalled relationship under the previous administrations. As shown in the examples in Table 3.1, the Kim Dae Jung administration allowed inter-Korean dialogue not only by pro-Sunshine Policy civil organizations but also by the opposition party leader, who had previously condemned the Policy.

Table 3.1 The inter-Korean exchanges at a non-governmental level in the Kim Dae Jung administration (1998-2002)

Date	Non-governmental exchange between the two Koreas
February 1999	Announcement of 'multiple channel policy'
September 1998	Establishment of the Korean Council for Reconciliation and Cooperation (KCRC)
July 1999	KCRC proposed a conference attended by political parties and social organizations
October 2000	An ROK delegation participated in the 55th anniversary event of the Korean Workers' Party
December 2000	The Korean Confederation of Trade Unions participated in a unification conference in Pyongyang
June 2001	The joint hosting of the first anniversary event of the inter-Korean summit by civic groups
May 2002	Park Keun Hye, the opposition party leader, held talks with Kim Jong Il
June 2002	IT professors in the ROK gave lectures in Kim Chaek University of Technology, Pyongyang

Source : MOU (2003)

### *Deregulation*

On the basis of the 'multiple channel policy' and the '*Jongkyong Bulli*' principle, the Kim Dae Jung administration announced a set of policy packages to liberalize the existing regulations in 1998 and 2001. It was mainly aimed at making it easier for South Korean companies to engage in business transactions with the DPRK. The administration announced in April 1998 that it would completely remove the ceiling on

investment by South Korean companies in the DPRK. The administration also eliminated the one million dollars ceiling for the export of machinery to the North and decided to give all South Koreans permission for multiple visits with one-off government approval. Before this newly revised regulation, multiple visits were only allowed for those working at the Shinpo site of the KEDO light water reactor project and Daewoo's Nampo factory (*Korea Times* 1<sup>st</sup> May 1998). This drastic measure to boost the scale and pace of investment toward the North offered Chung Ju Yung, the pioneering president of Hyundai Group, a critical momentum to kick-start the Mount Kumgang tourism project for which he had already signed a contract with the DPRK authority in 1989 (Song M.H. 2008). The South government at the same time expanded the number of industries allowed to invest directly in the North. Under the new regulations, South Korean investment in the North was mostly allowed with only a few exceptions such as electronic equipment, aeronautics, computer science and other defense-related industries. The government announced it would cut other administrative red tape governing inter-Korean trade. Under the new rules, smaller inter-Korean projects worth three million dollars or less, employment of North Koreans by South Korean companies in third countries and government projects could begin with one-step permission. The previous law had required all inter-Korean joint ventures or projects to undergo a two-step process to obtain government permission (*Korea Times* 1<sup>st</sup> May 1998). After the inter-Korean summit that pledged 'balanced' development of the national economy, the Kim Dae Jung administration announced some additional deregulation measures in 2001. It included an increase of maximum loan allowance from the government fund for South Korean investors planning business in the North,

relaxation of the repayment conditions, and widening of import and export items with the DPRK (MOU 2002).

The more significant progress in terms of how to further facilitate and safeguard inter-Korean commercial transactions from the likely uncertainty came from a series of crucial agreements with the DPRK authorities. The two Koreas reached an agreement in December 2000 with regard to some outstanding agendas governing inter-Korean trade such as double taxation avoidance, commercial dispute settlement, clearing settlement system, and investment guarantees (Je S.H. et al. 2004). These agreements removed a great obstacle to large-scale investment in the North. As a consequence, high expectations were aroused that these instrumental agreements would bring about longer-term, large-scale inter-Korean trade and investment projects with greater sustainability by strengthening a structural foundation of economic transactions between the two parties.

### *Theoretical interpretation*

The main question under this premise was which factor took priority : security or economy? Kim Dae Jung however acknowledged the likelihood of a simultaneous coexistence of the two issues in framing his foreign policy. He tried to substantiate his assumption by dealing with the two issues separately. His focus was how to remove the danger of the likely contradiction between the two issues. He pursued the '*Jongkyong Bulli*' policy by involving multiple actors to show that military conflict and economic engagement could coexist at the same time. He placed greater emphasis on how to

ultimately minimize the influence of the conflict in order to continue to put forward economic engagement. His policy consequently became a building block to ensure the continuity of inter-Korean trade in the next administration, who largely inherited the core spirit of the 'Sunshine Policy'.

There has been a great deal of research on the nexus between security and economy. However, the scholarly efforts in the IR discipline to understand security and economy in an interconnected fashion did not provide an adequate analytical framework to explain the Kim Dae Jung administration's economic engagement policy with the DPRK by the '*Jongkyong Bulli*' and 'multiple channel policy'.

The origin of the scholarship that tackled how the economic interactions affect the inter-state conflict dates back to the notion of Kantian Peace. The key logic of the Kantian Peace conception was encapsulated in Kant's assertion that 'the spirit of commerce cannot coexist with war' (Bohman and Lutz-Bachmann 1997). It formed one of the philosophical foundations for the liberal tradition in the international political economy (IPE) theory. The descendants of the Kantian Peace theory attempted to formulate the role of inter-state economic interactions in building and promoting peaceful relations between nations. The majority of the earlier theoretical attempts to explain the relationship were built on one solid hypothesis inspired by the Kantian Peace School. Their key assumption was that constant compatibility of these two elements was largely unthinkable. The only possibility that could be substantiated by the history of foreign policy was when and under what conditions a state employed either integration or a separation strategy of security and economy in its statecraft (Mastanduno 1998).

As the reality of international interactions became more complex, scholars turned their attention to how independent actors with clashing interests made efforts to enhance individual economic prosperity while avoiding military confrontation. Scholars in IR and IPE paid continued attention to the relationship between trade, among other economic interactions, and peace building processes. They produced contending arguments reflecting the dichotomy between realism and liberalism. Liberals argued that heightened economic exchanges inhibited international conflict and that, as a result, commercial openness contributed to peace-building (Rosecrance 1986, Kaysen 1990). One shared conclusion of this set of studies among liberals was that a nation whose economic interests are deeply entangled with the other could not use military force to resolve likely conflict. Even during the Cold War, it was evident that the intertwined economic interests rendered military force unusable (Art 1980, 16-17). However, the liberal view has been criticized by many realists who insisted that uninhibited economic exchange can undermine national security (Buzan 1984, Holsti 1986). Realists rather argued that increased trade flows in the end led states to take military actions in an attempt to reduce their economic vulnerability (Gilpin 1981, 140-41).

Transcending the liberal-realist division, many scholars shared their view on the need to combine security studies and IPE in this increasingly interconnected sub-field (Knorr 1977a, Baldwin 1985, Kapstein 1992, Carporaso 1995, Moran 1996). Understanding trade and security in an interconnected fashion as a consequence became one of the most significant tasks for IR scholars as well as IPE scholars. Another scholar went further when he argued that a common framework would be needed in

international politics to synthesize the diplomatic, the economic, and the military agendas (Baldwin 1985).

Keohane later inherited liberals' theoretical tradition by labelling it as commercial liberalism (Keohane 1990, 177-79). The fundamental assumption of commercial liberalism was built on the classical economists' optimistic view over cross-border economic exchanges and their welfare effects earlier coined as 'comparative advantage' by David Ricardo. It was however institutional aspects of the interstate economic exchanges that Keohane prioritized by the labelling. It was, in his belief, the regularized patterns of economic exchange and orderly rules that would bring peace in international politics. In the meantime, economic analyses employing the quantitative statistical method were also attempted to measure a relationship between war and trade. There were, for example, positivist attempts and subsequent debates to substantiate whether a war diminishes trade volumes between enemies or not (Barbieri and Levy 1999, 2001, Anderton and Carter 2001).

It should be noted that what scholars like Keohane, Barbieri and Levy, Anderton and Carter tried to find was a causal relationship between trade and military clash directed by state. However, viewing trade simply as one of many causal variables determining states' diplomatic or military behavior lost its analytical effectiveness. The assumption in which trade has been observed as an element either to inhibit or to trigger a 'military' collision was no longer persuasive. It rather resulted in neglecting, when tackling the influence of trade on international politics, an extremely broad spectrum of interstate conflict behavior ranging from verbal condemnation to use of armed forces and full-blown wars. This viewpoint could not provide an answer to explain economic

rationality which could not be controlled by government dictation. The focus in this subfield was being shifted to the growing transnational economic relations led by new actors which had previously been underestimated (Gilpin 1981). The growth of economic interdependence by newly-emerged actors and dynamics thus required a new analytical framework. The old framework failed to capture the essence of change facilitated by transnational actors. In this vein, two points should be stressed in evaluating the changed reality of international politics in general and the Kim Dae Jung policy in particular.

Firstly, the existing literature showed the propensity to analyze the security-economy nexus within an unchanged framework dealing with 'war and peace' primarily conducted by state actors. The literature placed a greater emphasis on interstate political negotiation. The literature that explored the nexus focused largely on how to enhance a state's capability by pursuing a nexus of the two policy tools against its potential adversaries (Mantanduno 2000). It did not pay sufficient attention to how to improve the economic potential of the national community which could be obtained by actively engaging even with hostile counterparts. Security concerns still prevailed in viewing interstate relationships in terms of foreign economic policy as long as they were undertaken in the situation of military tension. It thus underestimated the role of firms and business organizations as key actors in the newly-emerged transnational economic relations.

The increased attention to economic interest in the transnational environment required a different approach from the mercantilist assumptions in the past. Yet it was hard to deny that the security agenda subordinated economic issues in tackling the

nexus. It meant that the main research agenda was formed surrounding political decisions by state actors. One example was to mobilize economic means such as sanctions against the adversary nation (Knorr and Trager 1977). Economic requirements still remained in a secondary role. Non-state, economic entities such as firms and business organizations, which actually engaged in the exchange of resources and goods, were largely sidelined. Non-state actors were not treated properly in the scholarly arena dealing with the security-economy nexus. What motivated their participation in the transnational economic exchanges under the particular security dynamics did not attract sufficient interest in this subfield.

The literature, in turn, failed to provide a pertinent tool to explain the situation in the Korean Peninsula. Most of all, as non-aggression became the key agenda in the inter-Korean dialogues,<sup>19</sup> the possibility of an all-out war was considerably diminished in the Peninsula. The full-scale mobilization of the retained military capability in the two parties became highly unlikely from the 1990s (Kang 1998, 2003). The spirit of mutual accommodation began to burgeon instead at least in a limited sense. This changed military dynamic in the Peninsula weakened the explanatory power of the existing security-dominated discourse. The decline of the explanatory utility of the security-trade nexus approach was also valid in explaining Kim Dae Jung's policy initiative which pursued a 'delinking' of the two issues. His pursuit of the separation of security and economy was an effort to overcome the numerous previous attempts that had linked them. Kim Dae Jung rather made every effort to diminish the impact of the

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<sup>19</sup> The mood of the inter-Korean non-aggression culminated when the two Koreas agreed to sign the 'Basic agreement for reconciliation, non-aggression, exchange, and cooperation' in 1992. See MOU (1992).

politically hostile relationship which was likely to hamper inter-Korean economic engagement (Kim D.J. 2004). The main vehicle that helped make the separation sustainable throughout his presidency was what he called the '*Jongkyong Bulli*' and the 'multiple channel policy'.

He particularly emphasized the role of subnational actors in the transnational economic relations between the two Koreas. He made more efforts to encourage the participation of non-state actors such as private firms and civil organizations in the inter-Korean economic engagement (Kim Y.Y.2005). Given the pattern of changes in the international relations that Kim Dae Jung's 'Sunshine Policy' captured, the existing literature on the security-economy nexus showed limitations in explaining his foreign economic policy toward the DPRK.

Secondly, the security-trade nexus literature did not consider, with sufficient care, the increasing asymmetrical interdependence between states and between actors. The international politics portrayed by the security-trade nexus literature still reflected the political climate that required immediate actions and counteractions. The most viable option for a state to guarantee its sustainable prosperity was to select one of two choices. They were either to attack its adversarial power or to take defensive action against a given external threat as immediately as possible. The most significant task for a state commonly argued in the literature was to create a driving force to enhance its prosperity, removing the likelihood of military clash. The key logic of game theory (Snidal 1985, Morrow 1994) and prisoner's dilemma literature (Oskamp 1971, Wilson 1980, Alker Jr,

1981) was built on the necessity and inevitability of strictly 'conditional' exchanges on a *quid pro quo* basis.<sup>20</sup>

As a variety of non-state actors emerged, however, the reality in international politics began to change. New actors such as multinational corporations (MNCs) and civil organizations began to take an indispensable role in international politics. This phenomenon engendered and fostered 'transnational interactions' (Keohane and Nye 1972) among them. It provided a bigger space in which state and non-state actors' actions and counteractions could be interchanged and swapped. Changed world politics did not necessarily require bilateral balancing and strict equivalence between actors at the same level. Immediate repayment of political and economic debts by state actors in a strictly bilateral context was becoming less essential. The more realistic pattern of interactions between actors began to be disputed. It was an 'overall' balance 'within a group' argued mainly by neoliberal school scholars (Keohane 1986, 15-18).

One of the closest approximations to the changes of world politics was the conceptual formulation of 'diffuse reciprocity' by Keohane (Keohane 1986, 19-24).<sup>21</sup> He stressed the asymmetry of reciprocity which still enabled actors to cooperate with one another without immediate compensation. He wrote that less strict and less clearly specified equivalence could safeguard the continuity of cooperation. He insisted that a state's action could be compensated in a different sequence. The major factors in his formulation that made the continued cooperation possible were shared commitments and values and upgraded mutual trust and so on.

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<sup>20</sup> The concept of conditional action constitutes one of the classical defining characteristics of reciprocity. For discussion, see Gouldner (1960).

<sup>21</sup> The distinction of 'balanced reciprocity' and 'generalized reciprocity' by Sahlins was also useful to understand the asymmetry of reciprocity. See Sahlins (1972, 194).

The notion of 'diffuse reciprocity' however could not fully explain the inter-Korean engagement in the Kim Dae Jung administration. Kim Dae Jung's 'Sunshine Policy' apparently had a significant similarity to the notion. The 'Sunshine Policy' most of all was built on the premise that the outcome of inter-Korean negotiations does not necessarily have to guarantee 'equivalent' value exchanges and 'immediate' actions and reactions. He rather preferred 'sequential exchange' (a key element of diffuse reciprocity, Keohane 1986, 22) to elicit an obligation from a counterpart at any given time rather than a simultaneous one.

The 'Sunshine Policy' however aimed at forming a relationship of mutual engagement on a longer-term basis than diffuse reciprocity. One example was the asymmetrical holding of the two inter-Korean summits. After the first summit in 2000, Kim Dae Jung did not immediately urge Kim Jong Il 'to offer a quick lunch in return for his formal dinner'. The next inter-Korean summit plan already agreed in 2000 between the two top leaders was not implemented until 2007. It moreover was not between Kim Jong Il and Kim Dae Jung but between Kim Jong Il and Roh Moo Hyun, the next president of the ROK.<sup>22</sup>

Kim Dae Jung believed, regarding economic relations, that strengthening the DPRK's 'infrastructural capacity' in association with its economic institutions ought to be a policy focus in dealing with the ailing North Korean economy.<sup>23</sup> He stressed it

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<sup>22</sup> The Inter-Korean Joint Declaration announced in June 2000 reads that "Kim Dae Jung cordially invited Kim Jong Il to visit Seoul and Kim Jong Il agreed to visit Seoul at an 'appropriate' time" (*Chosun Ilbo* 16<sup>th</sup> June 2000). But the second summit talk also took place in Pyongyang.

<sup>23</sup> The definition of 'infrastructural capacity' was borrowed from the distinction between 'infrastructural' capacity and 'despotic' capability of Thomas. Whereas 'despotic' capability focuses on governing people, 'infrastructural' capacity put centrality on pursuing the effectiveness and legitimacy of the state's institutions. According to this distinction, the DPRK can be classified as a state which has strong 'despotic' capability and weak 'infrastructural' capacity. For the detailed discussion, see Thomas (1987).

would bring a more beneficial trade relationship between the two Koreas. His approach contrasted sharply with the longstanding perception on which the previous administrations' North Korea policy was based. The perception was that any efforts by the South to remedy the decay of the North's economic institutions would result in strengthening the military capacity of its adversary. Kim Dae Jung, unlike this long-running belief, encouraged the participation of ROK business actors in an effort to strengthen the DPRK's infrastructural capacity. Providing those who have prepared inter-Korean business with more discretion and autonomy made a great contribution to elicit the engagement of the ROK firms. This circular process of ROK business involvement → development of inter-Korean economic engagement → strengthening of infrastructural capacity to further support the accomplished engagement suggested a more flexible assumption than that of diffuse reciprocity. His belief on the positive contribution of business actors in creating politically cooperative relations was based upon the assumption of many liberals. Classical liberals demonstrated in many different ways that commercial intercourse increased contact and promoted reciprocal communication between private actors in different countries as well as between governments. Rising contacts and communications, in turn, were expected to foster cooperative political relations (Hirschman 1977, 56-63, Stein 1993, Doyle 1997, 251-300). In other words, they thought subnational actors such as consumers and firms had vested interests in commerce that led them to restrain the state when conflict is on the horizon lest the rising hostilities rupture important economic ties. It was especially the case under lack of supranational organization around the country-pair involved that

subnational actors have influence on security policy through their own commercial interests (Mansfield and Pollins 2001).

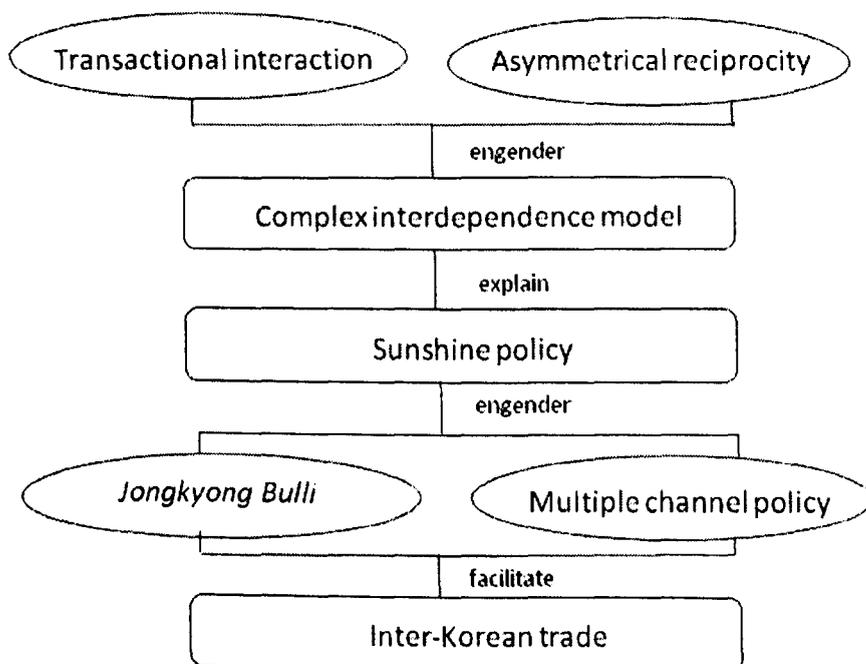
Kim Dae Jung's policy based on more liberal and flexible thinking in this sense demonstrated the fact that compensatory action toward each other could take place by a different actor in a different group. This meant the Kim Dae Jung policy initiative was not consistent with Keohane's assertion on the need for compensation 'within a group'.

The compensation behavior based on diffuse reciprocity, in addition, should be understood as the means to promote the production of public goods in international politics. Keohane stressed the importance to adopt a diffuse reciprocity-style standard of behavior in creating a more cooperative environment in the international regime (Keohane 1986, 20). What Kim Dae Jung sought to improve through his 'Sunshine Policy' did not lie within the realm of public goods, and did not place the ROK's state's material and realistic interest at the top of the agenda. Kim Dae Jung aimed to interrelate and harmonize the private interests of South Korean firms with the political reconciliation (public goods) of the two Koreas.

Kim Dae Jung's flexible approach on how to apply the notion of reciprocity to the reality of the inter-Korean relations did not ignore the need for conditional action (or contingency). The conditional action was a key principle of reciprocity since Gouldner suggested it (1960, 161). The distinctive point shown by his 'Sunshine Policy' was his emphasis on an even more flexible equivalence in defining the conditional action. His approach to adopt a different track from his predecessors thus adequately reflected the key pattern of change on which the complex interdependence model was predicated. It was the increasingly asymmetrical relationship of reciprocity.

To summarize, Figure 3.1 illustrates how to understand the theoretical background of the ‘Sunshine Policy’ in association with the complex interdependence model and shows a channel by which the Policy ultimately promoted inter-Korean trade. In this formulation, the upper part of Sunshine Policy shows the theoretical elements that generated the Policy in comparison with complex interdependence model, while the lower part explains its impact on the promotion of inter-Korean trade through its methodological initiatives.

Figure 3.1. Explanatory structure of the ‘Sunshine Policy’ and its influence on inter-Korean trade



### ***3.4 Inter-Korean relations under the Roh Moo Hyun administration (2002-2007)***

This section will focus on the Roh Moo Hyun administration's dealing with the nuclear crisis in connection with the economic cooperation with the DPRK that was inherited from the achievement of the Kim Dae Jung government. The section will shed light on Roh Moo Hyun's efforts to use economic incentives in inducing the DPRK to participate in multilateral talks for denuclearization. The development of the joint production project in the KIC will also be discussed focusing on how the nuclear crisis affected this project. This section will emphasize the similarity of Roh Moo Hyun's North Korea policy to the complex interdependence model in the light of his efforts to maintain economic engagement with the DPRK at the various levels.

#### *Nuclear crisis and economic incentives*

North Korea policy initiatives devised and implemented by Roh Moo Hyun, who was elected as South Korean new president in December 2002, seemed largely to inherit the Kim Dae Jung policy. One South Korean scholar dubbed Roh's North Korean policy as an 'Evolved Sunshine Policy' (Kim K.S. 2008, 13-23). As this suggested, his initiatives were built broadly on the continued pursuit of inter-Korean reconciliation, strengthening of economic ties, and dissolution of nuclear confrontation by means of dialogues and economic incentives (Roh M.H. 2003). A series of inter-Korean economic agreements such as railroad reconnections and successful launch of the KIC continued under the Roh Moo Hyun administration. The volume of inter-Korean trade under his leadership exceeded a billion USD for the first time since the two Koreas began bilateral

trade in 1988 (MOU 2006).

On the other hand, the revelation of the North Korean uranium-based nuclear program, which erupted just two months before his election victory, was a new challenge for the Roh government. The alleged North Korean nuclear program seriously constrained his policy choices in dealing with the arguably ‘nuclear-armed’ DPRK. His first guideline on such a crisis, most of all, was zero-tolerance of North Korean nuclear provocation. His administration nevertheless made every effort to maintain the existing course of inter-Korean cooperation. He outlined this combination of policy in his inaugural speech in February 2003.

The North should give up its nuclear development plan.....The North should decide on whether to possess nuclear weapons or to be assured of regime security and economic assistance (Roh M.H.2003).

A key vehicle that sought and brought about North Korean denuclearization during his term was a multilateral security arrangement better known as the so-called six-party talks. The six relevant nations including the DPRK adopted the so-called ‘September 19<sup>th</sup> Joint Statement’ in the fourth round of talks in Beijing. The statement, regarded as the most remarkable diplomatic achievement in the Roh Moo Hyun administration, outlined a range of compensation packages in return for the DPRK’s abandonment of ‘all nuclear weapons and existing nuclear program’ (MOU 2006). The underlying formula of this multilateral agreement was to swap the proposed economic engagement program – i.e. five parties’ commitment for trade, investment as well as

energy aid – and the denuclearization of the DPRK. The expression of willingness of the five parties to play significant roles in rebuilding the North Korean economy sent an auspicious signal which consequently induced Pyongyang to choose the peaceful option instead of the existing nuclear plan.

It should be noted that the Roh Moo Hyun administration utilized inter-Korean channels to reinvigorate the stalled multilateral talks by giving a full commitment to provide the DPRK with additional economic incentives. One of the key leverages that led to Pyongyang's return to the negotiation table after being dormant for over one year was the ROK's bold proposal made in June 2005. The Roh Moo Hyun government pledged in this proposal a provision of 2 million kilowatts of electric power through direct transmission from the South to the North, if Pyongyang reached denuclearization agreement in the six-party talks. The proposal made by Chung Dong Young, the then Unification Minister and special envoy to the DPRK, in direct talks with Kim Jong Il played a crucial role in bringing North Korea back to the six-party negotiation table (MOU 2006).<sup>24</sup>

The Roh Moo Hyun administration also made intensive efforts to institutionalize domestic and international actions to maintain improvements in inter-Korean relations. Domestically, the administration endeavored to institutionalize the accomplishments of inter-Korean rapprochement made by his predecessor to ensure the maintenance of inter-Korean economic projects regardless of political and military crisis. The Roh Moo

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<sup>24</sup> It was not clear that this proposal was the most crucial leverage to extract Pyongyang's decision to resume the talks. For example, Charles Pritchard, a former U.S. ambassador and special envoy for negotiations with the DPRK, stated that Pyongyang seemed to have already decided to rejoin the six-party talks and was simply looking for a justifiable momentum to announce it (Pritchard 2007, 109). But it was certain that such an economic incentive, along with China's continued efforts to persuade Pyongyang, created a key momentum to make multilateral talks jump-start.

Hyun administration enacted the 'Inter-Korean Relations Development Law' in 2005 and obtained the approval of the National Assembly for 13 documents on inter-Korean economic agreement signed by then (MOU 2008, 33-34). As a result, inter-Korean trade kept its momentum despite the heightening tension and security concerns triggered by the North Korean uranium-based nuclear program in 2002. Internationally, the Roh Moo Hyun administration gave up its central role in dealing with the DPRK by allowing the United States and China, and later Japan and Russia, to enter into multilateral talks with Pyongyang. Roh's endorsement of three-party talks (United States, China, and the DPRK, April 2003) in particular held without the ROK's participation was an expression of his government's practical approach favoring any pattern of dialogue without being obsessed by the modality *per se* of talks (Presidential Commission on Policy Planning 2008). Although the three-party talks ended up identifying a large gulf between Washington and Pyongyang, it laid a foundation on which the DPRK and the United States worked out a new six-party formula.

The new institutionalized multilateral body in which regional players involved cooperate with one another to defuse the North Korean nuclear program and to forge a peace regime in Northeast Asia became a main vehicle in resolving the nuclear issues and beyond (Funabashi 2007, Kurata 2007, Hong H.I. 2008). Although the six-party frame was designed to address ways to resolve the North Korean nuclear issue, the Roh government made efforts to effectively exploit it as a venue for building peace on the Korean Peninsula and shaping a new multilateral security architecture in Northeast Asia. For example, Roh Moo Hyun pushed the agenda of a peace regime in the Korean Peninsula, based on a South-North Korean peace treaty which aimed to replace the 1953

armistice and induced Pyongyang and Washington to join the regime (Moon C.I. 2008, 99-102).<sup>25</sup>

The Roh administration might well have believed that the increased interdependence between South and North Korea would play an integral role in repainting the overall picture of security environment in the proposed regime. The administration envisioned that deepening economic, social, and cultural interdependence between the two Koreas would enhance South Korea's influence on the North. The ROK's role, in this respect, could be defined as a leading diplomatic leverage to transform the isolated North Korean political and economic system. The ROK has also been believed to play a crucial role to help relieve mounting confrontation between the DPRK and the United States under the Bush administration.

However, Roh Moo Hyun's efforts to play the role of an 'honest broker' bridging Washington and Pyongyang in the proposed security regime was a real challenge to the conventional U.S.-ROK alliance (Brooke 2003). The challenge might result in cacophony between the two allies and in preventing them from closely coordinating their North Korea policy. For some conservatives in Washington, Roh's position was interpreted as conniving of North Korea's possession of nuclear weapons. The Bush administration, in addition, harboured a 'strategic suspicion' about the end of inter-Korean reconciliation in the broader context of Northeast Asia where China's role in this region was growing bigger (Park H.J. 2007). How to fill the gap between his obligations to the bilateral alliance partner in Washington and the realistic requirement

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<sup>25</sup> It is worth noting that the consensus on the idea of multilateral peace regime already existed in the 'September 19<sup>th</sup> Joint Statement'. The six-parties established five working groups one of which was for building a Northeast Asia peace and security mechanism.

for improved inter-Korean relations with Pyongyang became one of the biggest obstacles his foreign policy had to overcome.

### *Kaeseong Industrial Complex (KIC)*

The successful launch of the KIC project was the most salient achievement in the Roh Moo Hyun administration's engagement policy toward the DPRK. The DPRK designated Kaeseong in 2002, located around 4km north from the Military Demarcation Line (MDL) between the South and the North, as a special economic zone (SEZ). The North Korean Standing Committee of the Supreme Council of the People in November 2002 promulgated the 'Kaeseong Industrial Complex Act'. On the ROK side, Hyundai, as a key developer of the SEZ, sold factory lots in the complex to South Korean small and medium sized enterprises looking for low labor and land costs (Lim K.T. and Lim S.H 2003, Jung 2004). More than 41,000 workers, who belonged to 116 tenant companies, as of October 2009, were producing goods ranging from footwear to cooking utensils (MOU 2009). This remarkable progress of the Kaeseong project in his administration showed that military tension caused by the nuclear crisis did not undermine the need of South Korean business for a more interdependent economic structure with the DPRK.

Table 3.2 Key agreements in inter-Korean economic issues (2003-2007)

Accord	Date agreed
Establishment of the dispute settlement body in inter-Korean trade	November 2003
Joint irrigation investigation on the Im-jin river to prevent flooding	March 2004
Agreement on swapping light industry material (South) and mineral resources	July 2004
Inter-Korean maritime agreement	May 2005
Opening of the inter-Korean economic cooperation liaison office	October 2005

Source : Headquarter for Inter-Korean Dialogue, MOU (2008)

It was on the 31<sup>st</sup> October 2006 that all fifteen South Korean manufacturers, as the first tenant firms of the first phase (pilot complex) of the Kaeseong project, began to operate their production facilities in DPRK territory. The DPRK carried out an underground nuclear test just several days before this operation. The ROK and the US governments regarded the test as a rebuff to their repeated warnings on provocative actions. The nuclear test however did not create a serious obstacle to the planned timetable for the KIC operation. Further, South Korean businessman Park Nam So who had been running his company in the KIC depicted Kaeseong as ‘the most peaceful place in the Korean Peninsula’ even while the nuclear crisis continued to develop. His experience showed that under the already established governing order in this joint industrial complex there were few things to be discussed as a consequence of the exacerbating political mood. He stated in an interview (2008) that as long as his factory manager and the North Korean workers maintain a normal communication channel to meet production targets, there was no room for political variables to fit in this mechanism. He insisted that it was unfounded concern from suppliers, bankers, and consumer groups heavily influenced by irresponsible and exaggerated press reports on the future of the KIC, not the political variable *per se* that caused a problem.

The year 2006 marked ever-growing military tension. The DPRK launched missiles (July) and detonated nuclear material at its underground facility (October) in this year. Yet the South Korean SMEs in Kaeseong produced 74 million US dollars of goods in the same year. It marked nearly five times growth in comparison with the previous year's production. The number of the North Korean factory workers in the KIC rose over 10,000 in November 2006 for the first time (MOU 2006, 122-141, MOU 2007, 56-78).

The growing involvement of ROK business actors in the DPRK's territory engendered the need to have a freer business climate. It was more or less incompatible with the unfinished nuclear confrontation. The industrial infrastructure in the Complex however was equipped to mainly meet the South tenant firms' commercial requirements. It included power supply, telecommunications, banking and sewage disposal and so on. Agreements were also made on entry clearance to ensure freer and easier access to DPRK territory (Government Information Agency 2008, 354-357). All these follow-up agreements and their implementations aimed to form a more profitable and commercialized production environment in the DPRK. They contributed as a result to strengthening the asymmetrical interdependence between state and non-state actors in the two Koreas. Commercial production in the KIC, in addition, contributed to the growing inter-Korean trade. The volatile security environment in the Korean Peninsula did not undermine the growing economic engagement. The production in the KIC reached 16.7% (as of 2005) of the whole inter-Korean trade (MOU 2006, 122-141).

Another flagship achievement with regard to the inter-Korean economic engagement under the Roh Moo Hyun leadership (2003-2007) was the so-called 'light

industry cooperation agreement'. The ROK and the DPRK made an agreement in July 2004 to swap the material for the light industry production from the South with mineral resources such as zinc and magnesite from the North (Government Information Agency 2008, 354-357). The agreement created a new dimension of inter-Korean trade. It enabled a number of light industry manufacturers in the ROK to acquire a new consumer market in a very adjacent country. Along with this agreement, his administration also produced inter-Korean agreements on maritime issues (May 2004) and South-North railway connections (June 2004) as follow-up measures to implement the Kim Dae Jung - Kim Jong Il agreements in 2000.

### *Theoretical interpretation*

Roh Moo Hyun's North Korea policy could be interpreted as being shaped in accordance with the neoliberal thesis. His policy was built on the belief that economic cooperation and military confrontation can coexist under certain conditions. Unlike neorealist assumptions that security concerns always take precedence over economic matters (Grieco 1988), Roh's policy suggested that economic interdependency was sufficiently likely to pacify confrontation and unrest in international relations. He was an advocate of such neoliberal thinking that economic collaboration outweighs political division.

With regard to how to resolve the North Korean nuclear issue, he further believed that the DPRK is likely to sacrifice the existing course of nuclear development, under the condition that external economic engagement reaches a sufficient level, to overcome

its chronic economic insecurity. His policy line could be interpreted as challenging the realist formula arguing ‘preventing other countries from going nuclear, if they were determined to do it, is unlikely’ (Sagan and Waltz 1995, 37). A series of policy initiatives by Roh Moo Hyun showed that he perceived the underlying causes of the North’s attempts for nuclear armament were in fact to extract more economic concessions from its diplomatic counterparts. Whereas Kim Young Sam, in the similar pattern of nuclear crisis in the 1990s, insisted that the ROK government should take an unrivalled leading role in any level of negotiation with the DPRK, Roh maintained a more flexible approach. He rather focused on making favorable conditions upon which the United States and the DPRK could avoid a clash. In the light of such a perception, it was not surprising that Roh Moo Hyun used drastic economic means – additional energy aid provided by the ROK out of six-party talks – to make a breakthrough in the stalled nuclear negotiation.

He did not entirely dismiss the importance of military security in managing inter-Korean relations under nuclear confrontation. But he was fully aware, despite the fact that the South had maintained even more superior military capability than the North, how much the use of military force would be costly to South Korean economy and society.

“The spectre of war comes immediately to the minds of the Korean people when they hear talk of using force. As a nation that has built the Korea of today from the ashes of yesterday, we simply cannot be asked to relive that traumatic experience” (cited in Moon C.I. 2008, 75)

The proponents of the complex interdependence model did not claim that interdependence makes military power obsolete. They instead paid more attention to the costly effect of employing military means in a changing context of international relations (Keohane and Nye 1987, 727). The model offered insights for policy development of the Roh Moo Hyun administration when it tried to combine economic incentives with constant increases in the defence budget (*Naeil Shinmun* 27<sup>th</sup> September 2006) to deter North Korean nuclear development. As Roh Moo Hyun showed his belief that diffusion of economic collaboration could strengthen interdependence and subsequently alleviate military tension, his policy model had close parallels with the complex interdependence model.

His emphasis on the need for peace regime creation by negotiation in Northeast Asia constitutes another similarity to the complex interdependence model. Being able to comprehend how the regime is established and maintained was central to understanding the politics of interdependence not only for the proponents of complex interdependence model but for broadly defined neoliberals. They stressed the usefulness of cooperative multilateralism by showing a preference for hammering out a governing arrangement in a specified issue area. They disagreed with the realist theory that claimed only dominant players such as the United States are able to frame the rules in international agenda (Young 1982, Nye 1988, Powell 1994). Likewise, Roh Moo Hyun aimed to create a multilateral peace regime in the Korean Peninsula, subject to the successful progress of the six-party talks, to perpetuate denuclearization agreement among the powers involved. All in all, the continuation of inter-Korean economic collaboration in various issue areas,

coupled with the effort to replace military force as the key driving force of inter-Korean relations with economic means offered grounds to interpret his policy as aiming to create complex interdependence in the context of the Korean Peninsula.

### ***3.5 Changed nature of the inter-Korean relations : complex interdependence model***

This section will offer the complex interdependence model as the main conceptual framework to interpret the structural change of inter-Korean relations under the Kim Dae Jung and the Roh Moo Hyun administration. Such a theoretical attempt will suggest one of the fundamental explanatory tools by which one can understand a backdrop of the increased inter-Korean trade during the nuclear crisis. In doing so, this section will focus on the *process* of inter-Korean interdependence rather than the *consequence* of it. In other words, the main point of the section is going to be *how* they consolidated their interdependence rather than *why* they strove to achieve it. The formulation of the key characteristics of the complex interdependence model – lack of issue hierarchy, existence of multiple channels, and decreasing role of military – was the product of observation on how actors engage in cooperative endeavour in international politics. As the proponents spelled out, it was an explanation on the pattern of change during the 1970s and 1980s (Keohane and Nye 1989, xi). Thus, before tackling inter-Korean relations by the key characteristics of the complex interdependence model, these features of the change will be addressed first. This section will sum up the features upon which the complex interdependence model has been developed with two notions : asymmetrical reciprocity and transnational interactions.

The section will start by providing explanations on how these notions have been developed in association with IR theory and to what extent the key features of the notions have been found in inter-Korean cases. The section will then demonstrate three points to substantiate the applicability of the complex interdependence model to inter-Korean affairs after 2000. Firstly, it will show the increased exchange programs between South and North Korea after the inter-Korean summit talks in 2000. Secondly, it will argue that economic, cultural, and political interactions between the two Koreas consolidated its interdependence at the sub-state level. Thirdly, it will show that deepened interdependence between the two Koreas contributed to the transformation of the security environment in the Korean Peninsula.

### *Asymmetrical reciprocity*

Reciprocity was one of the most frequently quoted notions when tackling cooperative behavior between states.<sup>26</sup> According to Keohane (1986, 5-8), the concept of reciprocity in international politics was characterized by two common features : contingency and equivalence. He defined it as ‘exchanges of roughly equivalent values in which the actions of each party are contingent on the prior actions of the others in such a way that good is returned for good, and bad for bad’. It meant, if two states want to forge reciprocal relationship in international politics, they ought to respond to each other’s political actions with equivalent values of reward. One actor’s immediate

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<sup>26</sup> The concept of reciprocity was originally devised in establishing the post-War trade regime, and enriched through the debate on American trade policy. See Culbertson (1937) and Hay and Sulzenko (1982) respectively.

response to the other's actions and affirmative consideration of what the other desires to gain could be the main factors to strengthen reciprocity in a given bilateral relation.

The notion of reciprocity as one of the conceptual elements that engendered the complex interdependence model did not necessarily focus on dealing with mutually beneficial effects of equal weight between actors in terms of their political, economic or military capability. What needed to be more emphasized to explore international power politics was the asymmetrical aspect of reciprocity as one of the most influential elements in shaping one actor's behavior toward another.

The South Korean president Kim Dae Jung and his successor Roh Moo Hyun made a bold approach by proposing a more flexible type of reciprocity than what Keohane originally defined in the 1980s. In his inaugural speech, Kim Dae Jung made clear that his government unequivocally opposed the way of reunification by absorbing weaker North Korea despite the ever-expanding, overwhelming superiority that the ROK had been enjoying in economic and military capability (Kim D.J. 2004). Roh Moo Hyun's position in dealing with would-be nuclear North Korea has been seen as more amicable to Pyongyang when he emphasized the importance of so-called '*yokji Saji*' (易地思之, inter-subjective understanding, or placing oneself in the other's shoes) on how to assess the real intention of nuclear possession of the DPRK (Moon C.I. 2008, 77). He openly stated in his official visit to the United States immediately after U.S. president Bush started his second term.

North Korea professes that nuclear capabilities are a deterrent for defending itself from external aggression to protect itself from external threats. In many cases, it is true that North Korea's claims and allegations are quite hard to believe, and to credit. However, in this particular case it is true and undeniable that there is a considerable element of rationality in North Korea's claims (Roh M.H. 2004).

Although such controversial remarks were aimed at sending a message to the Bush administration to refrain from military or economic blockade toward the DPRK, they also signalled that he would take more flexible action in dealing with the North Korean nuclear program.

Kim Dae Jung and Roh Moo Hyun's initiative that stressed 'flexible reciprocity' became the main factor which could replace the neorealist understanding of inter-Korean relations in the previous administrations. Under the situation where South and North Korea had asymmetrical preferences with regard to their gains, the South's insistence on reciprocity might be perceived, for the North, as a disguised type of unilateralism (Park K.Y. 2007, 103). This political situation reduced the efficiency and usefulness of what Axelrod called 'tit-for-tat' strategy (Axelrod 1984). Regarding the evolution of inter-Korean relations, it meant an even more accommodative attitude toward the DPRK. The new approach on how to create reciprocal relations with Pyongyang was at variance with the Kim Young Sam administration (1993-1998), which had remained rigid in insisting on immediate give-and-take style reciprocity (Choi W.K. 1998). Kim Dae Jung and Roh Moo Hyun nevertheless made clear that their

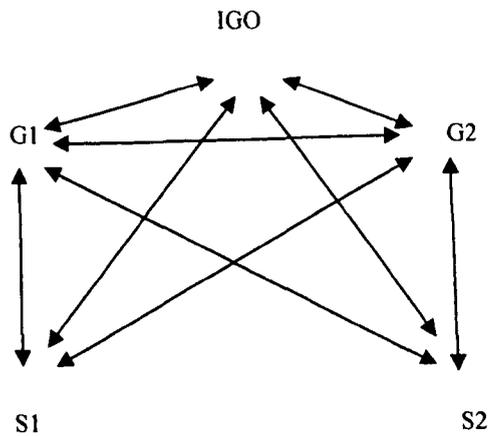
governments would not stick to the logic of a 'zero-sum' game in dealing with the DPRK. This implied the South Korean government would not oppose relative gains by North Korea as long as inter-Korean cooperation enhanced its absolute gains in economic interest like trade expansion. This initiative produced more active engagement by South Korean firms and civil society that were willing either to invest or to provide humanitarian aid to the DPRK. Kim Dae Jung and Roh Moo Hyun's approach based on the notion of 'flexible reciprocity' consequently broadened the issue areas and diversified the relevant actors in the inter-Korean relations.

### *Transnational interaction*

The notion of transnational interactions proposed in 1971 by Keohane and Nye constituted one of the two sources, along with asymmetrical reciprocity, that led to later formulation of the complex interdependence model. They stressed, by this notion, the changing nature of international politics that one could hardly capture through the conventional analytical framework focusing on diplomatic negotiations between states. Their key interest was cross-border transactions by actors not controlled by central foreign policy organs of government. This engendered the following definition of transnational interactions : 'movement of tangible or intangible items across state boundaries when at least one actor is not an agent of a government or an intergovernmental organization' (Keohane and Nye 1972, ix-xii). The key aspect, in this formulation, was the interactions between state and non-state actors. Figure 3.2 provides

another way looking at the direct interactions between a government in state A and a non-state actor in state B.

Figure 3.2 Transnational interactions and interstate politics



G1-G2 : Classic interstate politics  
 G1-S1 : Domestic politics  
 G1-S2/G2-S1/S1-IGO/S2-IGO  
 : **Transnational interactions**

G = Government  
 S = Society  
 IGO = Intergovernmental organization

Source : Nye and Keohane (1972) 'Transnational Relations and World Politics : An Introduction', p.xiv

The interactions between state and non-state actors implied that, for non-state actors, they could bypass their own governments when they tried to make a new channel with their counterparts. Kim Dae Jung and Roh Moo Hyun allowed, unlike their predecessors, South Korean firms and civil society groups greater room to manoeuvre in contacting their North Korean counterparts by relaxing various types of red tape and simplifying administrative procedures (Jeong S.H. 2001, 29). As a consequence, greater involvement of the South Korean non-state actors in inter-Korean affairs resulted in a more constructive pattern of economic engagement with the North.

Coupled with the rising demand of South Korean small business looking for lower cost production in the North Korean territory, the growing level of transnational interactions in the post-summit inter-Korean relations paved the way for the more stable development of a comprehensive pattern of interdependence between the two Koreas. Comprehensive and structural inter-Korean economic relations were supported by involvement of the South Korean business community that had strong reasons to press the government not to jeopardize their gains from inter-Korean trade.

Kim Dae Jung made clear in 2000, just before his summit with Kim Jong Il, that his government would aggressively encourage private sector cooperation and exchanges in inter-Korean relations (Kim 2000, cited in Son K.Y. 2006, 194). What he particularly stressed were the inter-Korea trade and the Mount Kumkang tourism projects. His emphasis on private sector cooperation and exchange further broadened and diversified the actors involved in inter-Korean engagement. He also made an effort to insulate inter-Korean economic exchanges by private sectors from the anticipated political unrest in the Korean Peninsula by introducing the principle of '*Jongkyong Bulli*' in his North Korea policy (Kim Y.Y. 2005).

Roh Moo Hyun by and large followed in the footsteps of the previous administration in terms of the actors and pattern of inter-Korean economic cooperation. A set of new cooperative agendas and subfields were exploited to elevate the quality of joint economic projects under his leadership. Among many accords and agreements made during his term, were joint irrigation investigation to prevent flooding (March, 2004), light industry cooperation (July 2004), and maritime affairs (May 2005). As the scope of cooperation expanded, it became essential to involve many other non-state

actors that had previously not been part of inter-Korean interactions. It included local governments, a variety of quasi-governmental agencies not necessarily belonging to the Foreign Office / Ministry of Unification, and many other subnational organizations.

*Increased exchange programs : No issue hierarchy*

Kim Dae Jung and Roh Moo Hyun abandoned an obsession with the negotiation agendas resulting from the Cold-War legacy, in dealing with the DPRK, such as legitimacy rivalry, military build-up, and ideological confrontation. By making a commitment not to pursue the downfall of the increasingly unstable communist regime, they achieved a remarkable expansion of inter-Korean economic, political, and cultural ties (Moon and Steinberg 1999, Hong S.Y. 1999, Moon C.I. 2008).

Kim Dae Jung suggested a 'comprehensive engagement' as a means to dissuade the DPRK from taking military action to counter perceived threats from external powers. Comprehensive engagement was understood as a process mobilizing all possible means that a status quo power could employ to induce its enemy state to change its behavior (Son K.Y. 2006, 46). He spelled out in the Inter-Korean Joint Declaration, as a result of the summit with Kim Jong Il, that he would pursue even more practical steps than the previous administrations toward enhanced inter-Korean economic, social, and cultural exchanges and cooperation (*Chosun Ilbo* 16<sup>th</sup> June 2000, Snyder 2005, 95). In the wake of the summit agreement, the military dynamic, building on 'zero sum' logic, no longer exclusively dominated the negotiation agenda in the inter-Korean political dialogue. Kim Dae Jung instead paid special attention to the growing necessity

for non-political, non-military and economic exchanges between South and North Korea in an attempt to expand the scope and scale of engagement. For example, the ambitious tourism project to develop Mount Kumkang into an attractive resort park initiated by Hyundai Group, although the ROK business community was skeptical about the project from the beginning, was an effective showcase to expose the administration's determination for comprehensive engagement.

The Roh Moo Hyun administration further developed a variety of ideas leading to non-political and non-economic cooperative events even amid nuclear confrontation. Socio-cultural exchanges began to take equal rank with political and economic dialogues between the South and the North. Inter-Korean socio-cultural joint projects in the Roh Moo Hyun administration underwent a significant growth – more than four times those in the Kim Dae Jung era – resulting in forming a mood of inter-Korean reconciliation in spite of nuclear tension. The joint projects included friendly football matches, restoration of the Buddhist heritage in the North, charity hospital construction, a South Korean pop singer's recital in Pyongyang, publication of a Korean language dictionary, and production of television programs (MOU 2007, 2008). As a result, the number of South Korean people who visited the North with the purpose of taking part in socio-cultural exchanges reached 12,217 in 2007 when Roh Moo Hyun was in power. It showed a dramatic increase in comparison with the 330 people who visited the North with the same purpose in 1999 in the Kim Dae Jung administration.

What was more striking was that these exchange programs were planned and enforced through not only intergovernmental channels but also various avenues at the sub-state level. At the same time, as socio-cultural joint projects came to receive

sustained attention not only by the relevant organizations but also by the individual government agencies, the clear hierarchy on what needed constant priority in inter-Korean relations has considerably diminished. The dividing line between conventional political issues and newly emerged cooperative agendas was becoming blurred generating a more structurally entangled cooperative mechanism between the two Koreas. Increased exchanges and cooperation at the socio-cultural level showed the diminishing issue hierarchy in inter-Korean relations.

*Interdependence at substate level : Multiple channels*

Kim Dae Jung and Roh Moo Hyun allowed and encouraged South Korean private firms and civic group leaders to engage with their counterparts in North Korea through various contact channels. This was a great policy reversal from his predecessor Kim Young Sam who largely prohibited inter-Korean contact at the subnational level outside inter-governmental channels. This new approach implied that the ROK government was likely to take a more accommodative attitude toward the DPRK, which had rejected intergovernmental dialogue with the democratically elected South Korean government and aiming to embrace, as negotiation partners, pro-North Korean campaign groups in the South instead (Park Y.K. 2003, 30). It also meant that the South Korean non-state actors could enjoy a higher level of autonomy in getting involved in joint projects with their North Korean counterparts. The consistent implementation of a series of deregulation measures based on the initiative of ‘multiple channels’ and the ‘*Jongkyong Bulli*’ by Kim Dae Jung was signalled by the key pattern of change – i.e. flexible

reciprocity and transnational actors' involvement in inter-Korean relations - on which the complex interdependence model was built. More diversified contact channels between the two Koreas showed the applicability of what Keohane termed transnational relations. This meant domestic actors in state A could deal politically with their counterparts of state B in their own issue area without necessarily involving diplomatic negotiation for the particular project (Keohane 1972, xii-xv).

However, the notion of transnational relations provided an insufficient tool in explaining the changed modality of inter-Korean contacts. This was because the key issue areas in the new phase of the inter-Korean relations did not reflect the emergence of new issues areas resulting from globalization, such as transnational banking activities and cross-border ecological/environmental issues. To understand the key features of the inter-Korean relations under the Kim Dae Jung government, it required a different analytical view not assuming supranational issues and actors closely associated with the notion of transnational interactions. By ruling out supranational approaches, revealing how intergovernmental bargaining at various levels worked in inter-Korean relations became the main task for the relevant research.<sup>27</sup>

A joint research project that analyzed the governance of inter-Korean economic cooperation, led by the Korea Institute for National Unification (KINU), showed how various actors formed a network through multiple channels, in pursuing inter-Korean projects for economic cooperation. The authors adopted a new approach, in explicating inter-Korean economic engagement after 2000, by stressing various actors' cooperation

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<sup>27</sup> The difference between supranational and intergovernmental approach in part derived from the result of theoretical observation on European integration process. For example, see Haas and Schmitter (1964) and Moravcsik (1993,1998) respectively.

and coordination rather than intergovernmental political negotiations. They particularly shed light on the emergence of the various actors' autonomous coordination through a horizontal network structure (Kim K.R. et al 2007, 6-8).

Individual actors which had been overlooked in the state-centric analyses developed into equally significant objects of exploration in dealing with inter-Korean relations. Jonsson (2006), for example, analyzed the role and influences of inter-Korean socio-cultural exchanges, by focusing on a functionalist perspective, on inter-Korean political reconciliation. Non-governmental organizations (NGOs), international financial institutions, and international humanitarian agencies received more attention in terms of the economic and social engagement in the DPRK (Weingartner 2001, Babson 2002, Beck and Reader 2005).

When it came to the non-state actors' contribution to the promotion of inter-Korean reconciliation in South Korea, more examples could be provided. Local governments in the ROK created their own contact channels in order to launch cooperative projects to fulfil their own people's industrial needs. The projects included orchard development, forest conservation support, and medical support for North Korean vulnerable groups (MOU 2008, 195-197). Many of the South Korean local governments that took part in these joint projects were under the control of the opposition party that was at odds with the Roh Moo Hyun administration over its North Korean policy line. Although the opposition party politically condemned the Roh administration's 'appeasement' approaches toward the DPRK, the local governments' industrial interest in inter-Korean economic cooperation was not outweighed by the party policy line.

More direct involvement of business channels in inter-Korean political affairs was shown when Hyundai played a crucial role in engineering the inter-Korean summit between Kim Dae Jung and Kim Jong Il. According to Kim Dae Jung's top aide group members who were secretly involved in the preparation of the first inter-Korean summit, it was the Hyundai Group that initially bridged the South and the North in order to make it happen (Son K.Y. 2006, 106, Lim D.W. 2008, 25-30). Such an impact of the business channel on interstate political deals showed that non-governmental elites were taking over the role of transmission belt between governments. Individual exchanges by non-governmental sectors could catalyze intergovernmental negotiation for state actors to achieve political goals. It demonstrated the possibility for concerted collaboration between state and non-state actors by making use of multiple channels in engaging with its potential adversary.

It was not only on the South Korean side that multiple channels efficiently worked to establish the implementation strategy of engagement driven by the ROK government. Civic group leaders in both Koreas established a 'Joint Committee for the Implementation of the inter-Korean Joint Declaration (JCKJD)' in 2005. More than twenty individual organizations from both sides participated in the Committee. On the North's side, it ranged from the Youth League and the Women's Union to the Farmers' League and the Religious Associations. The JCKJD hosted in June 2005 a 'National Unification Grand Festival' in Pyongyang to commemorate the fifth anniversary of the 2000 summit. The Committee also hosted in August 2005 another National Festival in Seoul to commemorate the 60<sup>th</sup> anniversary of Korean liberation from Japanese colonial rule in 1945. More than three thousand participants gathered for both joint events

(JCKJD 2005).

The DPRK also began to understand how international organizations and NGOs worked to engage in famine and poverty issues in international politics. Pyongyang made an unprecedented appeal for humanitarian assistance in 1995 after a series of natural disasters that devastated its economy. It allowed the international humanitarian agencies and their practitioners physical access to over two-thirds of its geographical area (Smith 1999, 453-54). Pyongyang, on the other hand, also decided in 1995 to accept the offer of unconditional food assistance from the then Kim Young Sam government in South Korea (Kim W. K. et al. 1998, 519). Given that there were no such things as NGOs or independent actors free from governmental control in the DPRK's language in the 1990s, this move implied a significant change in terms of how Pyongyang acknowledged the role of multiple channels in its foreign policy (Smith 2005b).

With regard to the DPRK's increased foreign engagement and inter-Korean economic cooperation after 2000, the Chosun Asia-Pacific Peace Committee (CAPPC), a quasi-governmental organization, played a crucial role. The CAPPC was in effect under the control of the Korean Workers' Party although it did not belong to the Party's official subunit (Kim K.S. 2002, 105).<sup>28</sup> According to the National Intelligence Service (NIS) in the ROK, the CAPPC, established in 1994, had three functions. Firstly, the Committee was a channel for improving relations with Western countries including the U.S. and Japan. Secondly, it planned and coordinated inter-Korean dialogues and overall

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<sup>28</sup> It should be noted that the North Korean main negotiators involved in inter-Korean economic and social exchanges were agencies belonging to mostly government authorities whereas the South Korean counterparts were non-governmental actors in private sector.

exchanges at the sub-state level. Thirdly, the CAPPCC acted as an avenue to invite influential foreign figures to the DPRK (Son K.Y. 2006). The CAPPCC, most of all, was the main counterpart of the Hyundai Group that had promoted the largest scale inter-Korean economic cooperation and exchanges since the 1990s. Business talks at the corporate level between Hyundai and the CAPPCC developed into political dialogue at the governmental level in the two Koreas.

The coexistence and interaction of state and non-state or sub-state channels such as the JCKJD and the CAPPCC as well as private firms like Hyundai showed the theoretical adequacy of the complex interdependence model in understanding the transformation of inter-Korean relations after the summit. The emergence of multiple channels was not necessarily to dismiss the role of diplomatic negotiation and military capability highlighted by the political realists. It was worth noting that the proponents of the complex interdependence model accepted that state behavior was dominated by the constant danger of military conflict. They however paid equal attention to the newly emerged multidimensional economic and social interdependence (Keohane and Nye 1987, 727). Inter-Korean relations after 2000 likewise did not imply the retreat of the state as the supreme political actor. It rather demonstrated that the state did not monopolize agenda setting and instead formed a network with alternative actors which had previously been sidelined. The non-governmental elites, as one axis of this network, began to be treated as equally important actors in producing and developing the agendas and issues of inter-Korean negotiations. It would be misleading to argue that non-governmental elites were becoming competitors of the nation state. Quite to the contrary,

the inter-Korean engagement by non-governmental actors was largely supported and consolidated by intergovernmental bargaining.

One of the most illuminating pictures showing to what extent the ‘multiple channel’ policy actually reorganized the practice of inter-Korean contact came from the survey results of the South Korean businessmen who have conducted inter-Korean business. 54 percent of the South Korean businessmen who took part in the survey answered that the ROK government allowed direct contact between South and North firms apart from the inter-governmental channel. This result showed that the ROK government made an effort after 2000 to insulate trade negotiations and transactions from the negative influence of the volatile military dynamics. The inter-company direct contact as a consequence became a main avenue for inter-Korean trade deals after 2000 (42%), according to the relevant question. The role of the direct channel between companies surpassed inter-governmental negotiations (12%) and indirect contacts through third parties (19%) in creating a sustainable dialogue route for future transactions.

Figure 3.3 Did the ROK government permit non-governmental level contact with the DPRK entities after the 2000 summit talk?

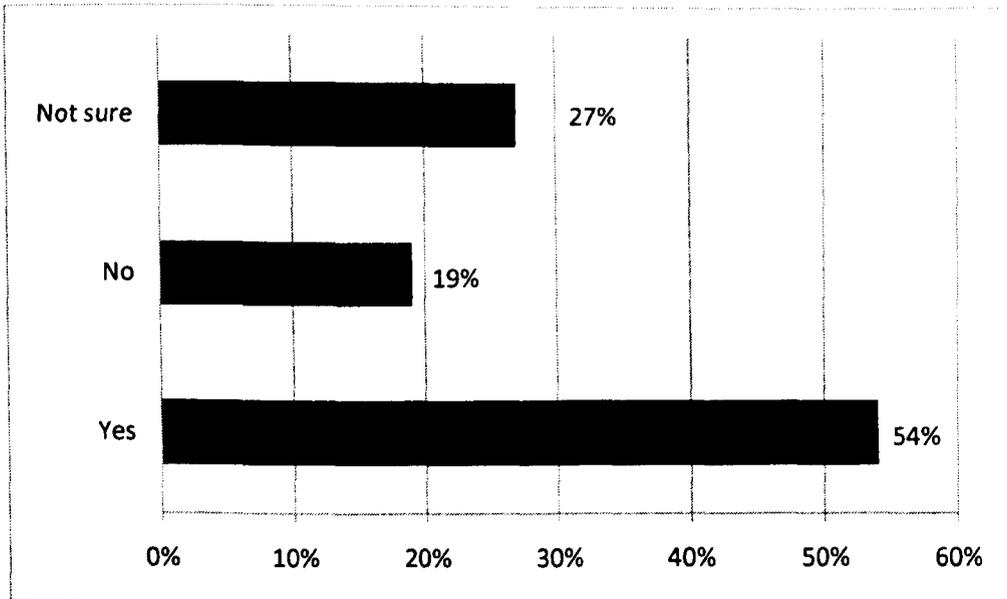
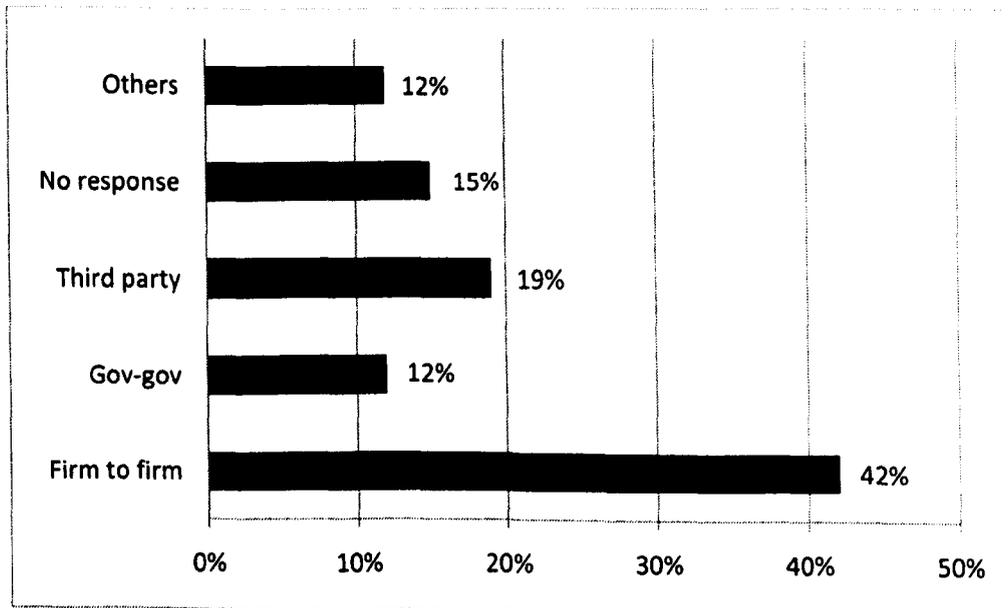


Figure 3.4 Which was the key contact channel with your North Korean business partners after the inter-Korean summit in 2000 ?



In sum, the political agreement in 2000 to invigorate cooperation and exchanges in various non-political areas promoted the role of sub-state actors on both sides. As a result, increased socio-cultural exchanges and sustained economic cooperation after

2000 further strengthened the interdependence between the two Koreas through various channels. The emergence of the new dialogue channel in the inter-Korean interactions ultimately affected the security environment in the Korean Peninsula.

*Change of the security environment : Decreasing role of military*

The examples of inter-Korean economic cooperation after the 2000 summit showed how politically hostile states could share their self-interest through institutional agreements. The case of the KIC, above all, provided a compelling example of neoliberal thinking on inter-state cooperation through institutional arrangement.

The Kaeseong Industrial District Management Committee (KIDMAC), as a governing body to run this joint industrial complex, was established as a corporation belonging to the DPRK government based on article 21 of the Kaeseong Industrial Complex Act. On the other hand, the Committee however was staffed by South Korean quasi-government officials. The Committee operated through a conference with a North Korean government agency, the Central Special Zone Development General Bureau (KIDMAC 2008). In addition, bilateral written agreements between the two Koreas were made through KIDMAC on various issues such as customs clearance, quarantine, telecommunications and entry/departure.

The joint organization, KIDMAC and a variety of written agreements between the two Koreas became the key vehicles that embodied and coordinated their joint stake regarding the management of the industrial complex. Although both governments played key roles in designing and launching the organization, they shifted more or less their power to the joint organization to achieve mutual benefit. KIDMAC had the status

of an independent legislative body which had a distance from hierarchical order of the North Korean central authority. Due to the dissimilar legislative procedures between South and North Korea, however, they chose a way to divert likely clashes in legislation. The South Korean government in many cases arranged the first draft of the relevant bills and then sent them to the North through KIDMAC. After the North examined them by consulting with the tenant companies, they were made public as key laws and bylaws to govern the Complex (Kim K. R. et al. 2007, 102-104). As Keohane and Nye illustrated, states can broaden their perception of self-interest as they comply with the rules of cooperative institutions. Inter-state cooperation, without the presence of a hegemonic player, could be enhanced through institutional agreements. In other words, states could shift loyalty and resources to institutions if these were mutually beneficial (Keohane and Nye 1977). The establishment and operation of KIDMAC demonstrated this fundamental assumption of neoliberal institutionalism could be applied to the case of inter-Korean relations.

From this procedure, one could discover two main features which undermined the logic of the neorealists. Firstly, the issue of relative loss emphasized by neorealists did not constitute the main agenda in establishing and expanding the Complex. Each other's economic stability, in contrast, became the most important factor which guaranteed the continued supply of capital and labor from both sides (Kim K.R. et al. 2007, 102-104). Secondly, neither party had a dominant power in drawing up the universal rules under which the interdependency expanded. There were a few cases where one side made an official complaint against the other regarding unevenly distributed power in every phase of legislation. The most frequently debated issues were about the procedure of

entry/departure, the use of telecommunications including the internet, and customs clearance (Kim K.R. et al. 2007, 14). All these issues raised by the South Korean tenant companies, however, were to do with promoting more production and providing more convenience for the companies. The issues were discussed, even from the North Korea's perspective, not based on the logic of a zero-sum game but based on how to adjust the pace of change for economic reconfiguration in this particular area.

Once KIDMAC began operation it contributed to diminishing the security tension in the bordering area between the two Koreas. The sign of reconciliation formed through economic collaboration culminated when the DPRK military, which formerly had been stationed in the vicinity of Kaeseong, showed no objection to the influx of South Korean government officials and workers as well as information technology devices. The North Korean armed forces that had been stationed in or around the Complex furthermore handed over a part of this strategic point to newly built industrial facilities (Hwang I.D. 2004).

According to Rosecrance (1986), growing economic interdependence and the benefit from it changed the state's attitude to its territorial control against past adversaries. Similarly, the KIC project undermined military control in this situation over North Korea's own territory for the first time since the armistice in 1953. The redeployment of the North Korean army out of Kaeseong demonstrated that institutionalized economic collaboration could transform the security environment that had been dominated by the long military confrontation. This became a symbolic episode that showed the declining efficacy of military force as a tool acquiring material benefit in the inter-Korean relationship. There was no reason, in this sense, for the DPRK to

militarily threaten its commercial partners, whose hard currency influx and capital investment was essential to maintaining its own economy. The DPRK's dependence on the South for economic assistance and investment precluded military attack or subversion attempts against the South (Smith 2005a, 49).

The diluted hostility through various exchanges and joint events at the sub-state level promoted a national mood of reconciliation and coexistence in the Korean Peninsula after 2000. One exception was a naval skirmish in the Yellow Sea in 2002, in which six South Korean seamen were killed. The North's unexpectedly rapid expression of regret, however, eased the tension which might have resulted in a broader military standoff (*New York Times* 26<sup>th</sup> July 2002). The changed security environment in the Korean Peninsula undermined the conventional security discourse framing inter-Korean relations. For example, the notion of 'hawk engagement' suggested by Victor Cha (2002) rested on the assumption that the DPRK had an unchanged intention to overthrow the Seoul regime to reunify Korea under communist rule. Unlike his underlying assumption, however, the deepened interdependence between the South and the North decreased North Korea's need and desire to replace the South Korean government with a pro-communist regime. This also illustrated that the complex interdependence model which paid heed to the retreat of military force in an interdependent relationship could provide the analytical tool in understanding the changed nature of inter-Korean relations after 2000.

### ***3.6 Conclusion***

In this chapter, the changed nature of the security environment of the Korean Peninsula after 2000 was contrasted with the conventional security perception building on the tense military relationship explored in chapter 2. The nuclear crisis between 2002 and 2006, derived from North Korea's nuclear ambition combined with the Bush administration's policy shift from the Clinton government, further escalated security instability in the Peninsula. Unlike the US-DPRK relations, however, inter-Korean relations after 2000 could be explained by a different theoretical model. The complex interdependence model which Keohane and Nye (1977, 1989) formulated to challenge realist assumption could provide a useful analytical tool for understanding the changed inter-Korean relations after 2000.

Despite the increasing tension between the United States and the DPRK, the increased inter-Korean interactions revitalized the mood of reconciliation between the two Koreas. The multiple dialogue channels at the sub-state level, created as a result of the 2000 inter-Korean summit, promoted this change. The inter-Korean mutual engagements in the various issue areas such as socio-cultural joint projects as well as economic cooperation contributed to the change of the Korean security environment. The consolidation of the inter-Korean relationship after 2000 demonstrated elements of the key characteristics of the complex interdependence model formulated by Keohane and Nye. The complex interdependence model was able to explain the emergence of multiple channels of inter-Korean interactions in various subfields outside the political and military security agenda. The model also helped explain the involvement of South

Korean small and medium sized enterprises in inter-Korean trade despite increased security instability caused by the nuclear crisis.

## CHAPTER 4

### Nuclear crisis and inter-Korean trade

#### **4.1 Introduction**

This chapter will show how and why the second nuclear crisis erupted and heightened from 2002 onward and contrast the crisis with the ongoing development of inter-Korean trade. Thus this chapter is divided largely into two parts : the nuclear crisis and inter-Korean trade. In the first part, the outbreak of the nuclear crisis and its development will be examined by focusing on the relevant players' intentions. This part will reveal the diplomatic rift between the ROK and the United States surrounding how strong bilateral or multilateral pressure upon Pyongyang should be exerted to achieve denuclearization of the DPRK. This chapter will argue that the ROK government's policy line of keeping a certain degree of distance from Washington's coercive diplomacy laid the foundation for a stable growth of inter-Korean trade during the nuclear crisis. The second part will explore the dynamics and development of inter-Korean trade particularly from 2002 onward. This part will shed light on commercial basis trade led by the South Korean business community rather than non-commercial trade such as the transfer of South Korean relief material for humanitarian aid for the North Korean people. It will argue that the increased commercial trade and large investment projects in the KIC was inspired and facilitated by the '*Jongkyong Bulli*' and 'multiple channel policy' proposed by Kim Dae Jung and supported by Roh Moo Hyun. To further explain the South Korean entrepreneurs' behavior during the nuclear crisis,

practical business conditions such as the profitability of inter-Korean trade and accessibility to North Korea will also be examined along with how they responded to such a reality. This chapter will conclude that the security tensions in the Korean Peninsula did not damage the economic interaction between the two politically adversarial countries.

#### ***4.2 Outbreak of the second nuclear crisis in 2002***

This section will assess how the second nuclear crisis erupted in 2002 and how the involved parties – the United States, the ROK, and the DPRK – reacted to the initial phase. The section will critically assess the background of the Bush administration's coercive nuclear diplomacy toward the DPRK and contrast it with the ROK government's position on how to relate its alliance partnership with the United States and inter-Korean relations.

##### *The US government perspective*

James Kelly, Assistant Secretary of State for East Asian and Pacific affairs, visited the DPRK between 3<sup>rd</sup> and 5<sup>th</sup> October 2002. He was the highest-ranking administration official to visit Pyongyang after President Bush took office in 2001. Assistant Secretary Kelly had a talk with Kang Sok Ju, the DPRK's First Vice Minister of Foreign Affairs during his visit. Neither side stated what they had discussed until the U.S. State Department made a formal announcement about the DPRK's nuclear program. The State Department announced on 16<sup>th</sup> October 2002 that the DPRK had been conducting a

major clandestine nuclear weapons development program. The Department made a statement that the DPRK admitted the existence of a high enrichment program of uranium (HEU) as fissile material for a nuclear bomb. According to the State Department, the DPRK officials' nuclear admission was the response to the American intelligence data suggesting a secret project was under way. Richard Boucher, State Department spokesman, said that "North Korea's secret nuclear weapons program is a serious violation of North Korea's commitments under the Agreed Framework as well as under the nuclear Non-proliferation Treaty (NPT), its International Atomic Energy Agency (IAEA) safeguards agreement, and the joint North-South Declaration of the Korean Peninsula." (U.S. Department of State 2002).

Assistant Secretary Kelly, in his speech of December 2002, stated that the United States now had a 'precondition' in resuming talks with the DPRK. He attributed this to the DPRK's HEU program (Kelly 2002). It superseded President Bush's earlier commitment to "resuming talks with Pyongyang in any time any place without precondition" (Niksch 2002). The U.S. announcement that it was halting talks with Pyongyang resulted in freezing the DPRK's relations with the regional powers. It overshadowed the move toward improvement of relations, attempted in September 2002, between the DPRK and Japan as well as between the two Koreas. Inter-Korean joint efforts to develop a non-political exchange through international sports events like the Asian Games faced difficulties. The North Korean economic reform program announced in July 2002 drew less attention due to the resumption of the U.S. – DPRK confrontation. A continued political standoff at the interstate level precluded the possibility of promoting non-political exchanges.

Being faced with the sudden collapse of the reconciliatory mood, critics had suspicions, in two key areas, about the manner of the Bush administration's approach in handling the North Korean HEU program. They pointed out the imprecision of the intelligence assessment with regard to the HEU program and the timing of its revelation by the State Department. Regarding whether and to what extent the U.S. intelligence entailed precise data, one of the most reliable documents was the Central Intelligence Agency (CIA) report assessing the DPRK's nuclear capability, submitted to the U.S. Congress on 19<sup>th</sup> November 2002. The CIA concluded in this report that "the DPRK embarked on the effort to develop a centrifuge-based uranium enrichment program about two years ago" (CIA 2002). The CIA however spelled out that there was no evidence indicating that Pyongyang had begun constructing a centrifuge facility by then. The CIA's assessment as reported to Congress covered only three things. Firstly, the CIA concluded that the DPRK had begun seeking centrifuge-related materials in large quantities in 2001. Secondly, the CIA concluded that the DPRK had obtained equipment suitable for use in a uranium feed and withdrawal system. Thirdly, the CIA concluded that the DPRK was constructing a plant that could produce enough weapons-grade uranium for two or more nuclear weapons per year when fully operational. Of these three claims made by the CIA, the only activity the DPRK had completed toward developing nuclear weapons as of October 2002, when Kelly visited Pyongyang, was the purchase of equipment for uranium feed and withdrawal. When it came to the material and the plant that could make the DPRK's aim at developing uranium-based nuclear weapons viable, the CIA did not provide any reliable intelligence by the time of Kelly's visit.

The CIA did not specify in its 2002 Congress report what kind of equipment the DPRK had purchased. As Mozley (1998) wrote, the enrichment of 0.7 percent content of uranium-235 isotope to 93 percent content required a complex and sophisticated technological process. Such processes also needed a number of mechanical devices and parts. They included, for example, electrical-frequency converters, high-purity cobalt powder for magnetic-top bearing assemblies, and high-strength aluminium tubes (Harrison 2005, 104). The CIA provided no intelligence on which of these devices the DPRK had actually acquired. It instead merely asserted the existence of a poorly defined HEU 'program' with scant evidence.

The imprecise intelligence on the DPRK's nuclear-related activities supplied by the U.S. intelligence agency produced different and non-verifiable presumptions about the North's nuclear capability. The U.S. presumptions about the DPRK's capability to develop nuclear weapons ranged from 'the possession of one or possibly two nuclear weapons so far' (CIA 2002) to 'the capability to produce dozens of nuclear weapons annually in case it follows its current course' (Allison 2004, 72). Newman (2004,77) argued that the DPRK was capable of producing enough material for five to eight more nuclear weapons within a year if it reprocessed spent fuel rods. What he cited as evidence was the unclassified report to Congress made by the Director of Central Intelligence (DCI). In short, the unclear and inadequate explanation of the evidence that Kelly provided to the DPRK negotiators during his visit undermined the reliability of the U.S. claim that the North had violated the 1994 Agreed Framework. The evidence provided therefore could not justify the U.S. decision to halt all bilateral dialogues to implement the 1994 agreement.

The second point the critics raised was the timing of the Bush administration when it unveiled the alleged existence of the DPRK's HEU program. Kelly stated that the Bush administration received conclusive information about the DPRK's pursuit of the HEU in summer 2002 (Kelly 2002). The critics, however, pointed out that Washington deliberately postponed the revelation of the HEU intelligence it had already obtained in the Clinton years. For example, McCormack argued that Washington probably received intelligence in 1999 about Pakistan's transfer of an unwanted gas centrifuge for uranium enrichment to the DPRK (McCormack 2004, 161). It was evident, as Kelly himself acknowledged, that the North's HEU program began well before the Bush administration (Kelly 2002). The critics, on this basis, argued that the Bush administration's revelation of the HEU program they have long been holding at that particular time was an attempt to seek a pretext to torpedo the 1994 Agreed Framework. McCormack asserted that Kelly did not go to Pyongyang to negotiate but to confront the DPRK with proof of its past nuclear activities (McCormack 2004, 160)<sup>29</sup>.

According to the critics, the Bush administration broached the imperfect evidence on the HEU program for the purpose of scaring Japan and the ROK into reversing their North Korea policies (Harrison 2005). Japanese Prime Minister Koizumi Junichiro pushed strongly forward his plan to normalize diplomatic relations with the DPRK in 2002. The plan culminated when Koizumi met Kim Jong Il in Pyongyang in September 2002, just weeks before Kelly's visit to Pyongyang. Japan's speedy drive toward Pyongyang, however, was made without sufficient consensus with Washington (Rozman 2003, Laney and Shaplen 2003). The Bush administration felt the need to warn

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<sup>29</sup> There were a series of reports and debates on when the United States intelligence community detected the existence of the HEU program. For further discussion, see Son K.Y.(2006, 208).

its key East Asian ally to adjust its pace in establishing diplomatic relations with the DPRK.

The Bush administration, according to this theory, made use of the imperfect proof of the HEU program in pushing forward the goal it had envisioned since its inauguration. That goal comprised three objectives : the termination of the 1994 agreement, no reward to the DPRK before visible measures to dismantle the nuclear program, and a multilateral alliance to diplomatically press Pyongyang (Park H.J. 2007, 13-14).

The review of the inception of the 2002 nuclear crisis demonstrated the recurrence of inter-state confrontation in the Korean Peninsula. The Bush administration concluded in this sense that the coercive policy line toward Pyongyang was an effective tool to strengthen the state-centric, conventional security environment in the Peninsula.

### *The DPRK government perspective*

After the Bush administration announced in October 2002 that the DPRK had admitted its uranium-based nuclear program, the first response by the DPRK authority was a statement by the Ministry of Foreign Affairs spokesman. The DPRK made this statement ten days after the statement by the U.S. State Department. The DPRK still maintained an ambiguous attitude regarding the existence of the HEU program. The first point they emphasized was the lack of evidence.

Producing no evidence, he [Kelly] asserted that the DPRK has been actively engaged in the enriched uranium program in pursuit of possessing nuclear weapons in violation of the DPRK-U.S. Agreed Framework. He even intimidated the DPRK side by saying that there would be no dialogue with the U.S. unless the DPRK halted it, and the DPRK-Japan, the North-South relations would be jeopardized (*Chosun Shinbo* 26<sup>th</sup> October 2002).

Pyongyang maintained a 'neither confirm nor deny' attitude regarding the existence of any uranium enrichment activity aiming at nuclear weapon development by saying,

Nobody would be so naive as to think that the DPRK would sit idle under such a situation. That was why the DPRK made itself very clear to the special envoy of the U.S. President that the DPRK was entitled to possess not only nuclear weapons but any type of weapons more powerful than that so as to defend its sovereignty and right to existence from the ever-growing nuclear threat by the U.S. (*Chosun Shinbo* 26<sup>th</sup> October 2002).

The Foreign Ministry statement demonstrated an ambiguity. It was not easy to discern whether Kang Sok Ju was stressing the 'possession' of the HEU program or their 'right' as a sovereign state to possess a nuclear program. Their tactical ambiguity continued in the following paragraph ;

The DPRK, which values sovereignty more than life, was left with no other proper answer to the U.S. behaving so arrogantly and impertinently. The DPRK has neither need nor duty to explain something to the U.S. which seeks to attack it if it refuses to disarm itself (*Chosun Shinbo* 26<sup>th</sup> October 2002).

O Song Chol, bureau director of the DPRK Foreign Ministry, however, clearly denied in January 2003 that his government had admitted either enrichment activities or an active nuclear weapons program, saying it was a 'sheer lie'. His statement was released when the DPRK made its decision to withdraw from the NPT in response to the halted reward program that had previously been promised in the 1994 Agreed Framework.

I must make it clear here that we flatly denied at the early stage of the talks the U.S. accusations of our 'plan to produce nuclear weapons using enriched uranium'..... Washington's announcement as such was intended to mislead public opinion by fabricating a fiction (Kim J.Y. 2003).

Diametrically opposed explanations from Pyongyang and Washington surrounding what they had discussed in the Kelly – Kang Sok Ju meeting continued. The U.S. delegation reiterated their point.

At first, my counterpart angrily denied that the DPRK had an HEU program. He dismissed my statement, claiming it was a fabrication, but later, of course, the North Koreans took another line (Kelly 2002).

Don Oberdorfer had interviews with the DPRK negotiators to identify what was happening within the Pyongyang leadership. He wrote that Pyongyang's official response to the Kelly team's unexpectedly coercive attitude was presented as a result of an all-night meeting of its top officials (Oberdorfer 2002)<sup>30</sup>. This episode implied that there was an intensive internal debate within the DPRK top decision makers group on how to interpret Washington's unexpected message delivered by Kelly and what sort of tactics would be effective to cope with the particular situation. The outcome was a decision to seek an even more integrated approach rather than keeping the existing track to pursue a marginal advantage in specific conditions of its planned denuclearization road map. For the Kim Jong Il regime, the 1994 reward package, that had been established eight years ago and showed significant and unacceptable delay in implementation, required too patient an approach. They chose to risk a reversal of the existing game plan cautiously assuming a larger scale 'buy-out' option would still be available in the nuclear deal with Washington even if it would take more time than the original one. This decision suggested Pyongyang's preference for a broader deal and its desperation for a bigger compensation package on a long-term basis at the same time. As the studies of the DPRK negotiating behavior suggested,<sup>31</sup> a broader deal including

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<sup>30</sup> On the day-to-day schedules of the three day talks between the Kelly team and the DPRK negotiators, see Cha and Kang (2003, 132-33).

<sup>31</sup> For example, see Sigal (1998, 52-65,78) and Snyder (1999, 58-60).

security and economy issues were likely to work better than narrow proposals on specific issues. In this sense, the DPRK negotiators' decision implied that they had an intention to seek a greater goal in the future negotiations, if the Bush administration turned out to be clearly opposed to any compensation action for the DPRK. Pyongyang, in short, attempted to maximize its future leverage to acquire economic and security assurance by letting Washington reinforce its suspicion about the existence of the clandestine nuclear program.

As O'Hanlon and Mochizuki (2003b, 9) asserted, the economic atrophy that the DPRK has been facing was a fundamental motivation for its admission of the nuclear program. There were two written documents, jointly signed by the DPRK and the United States as an official agreement to finalize the two rounds of the nuclear negotiations. These were the Agreed Framework signed in October 1994 (U.S. Department of State 1994) and the DPRK denuclearization action plan agreed in February 2007 (U.S. Department of State 2007). Both agreements demonstrated that Pyongyang's aim was to secure economic resources to revive its economy as well as to gain an assurance of the survival of the regime.

The two parties made clear, in the 1994 Agreed Framework, that the top priority should be a cooperative role in constructing the promised light water reactor (LWR). The LWR was the main vehicle that would enable the DPRK authority to resolve the country's chronic shortage of electricity. Pyongyang, through the DPRK denuclearization action plan announced on 13th February 2007, also secured an even larger supply of heavy fuel oil from other members in the six-party talks. This was the first visible implementation measure at the initial phase of the second nuclear

agreement. Pyongyang might well conclude that the only way to get more economic assistance was to capture the greater attention of Washington. In this sense, restarting the Yongbyon nuclear reactor which had been frozen as a result of the 1994 Agreed Framework, as a response to Kelly's coercion, could be interpreted as a method to achieve that objective (McCormack 2004, 164).

The DPRK began to broach at the same time the issue of security from the threat posed by the United States armed forces. The spokesman for the DPRK Foreign Ministry insisted, on 25<sup>th</sup> October 2002, on the need for a non-aggression treaty with the United States. He argued that a non-aggression treaty had become a top priority of the diplomatic agenda between the two countries because the Agreed Framework had been killed (*Chosun Shinbo* 26<sup>th</sup> October 2002). Pyongyang also made a 'new bold proposal', at the first three-party talks that took place in April 2003, which implied the Clinton-style 'package deal' swapping diplomatic normalization and security assurance (*Chosun Shinbo* 24<sup>th</sup> April 2003). The three-party talks were the first inter-state attempt to listen to each other's arguments as a way of trying to settle the nuclear dispute that had arisen since the Kelly – Kang Sok Ju meeting. This initial response by the DPRK implied that its acute desire was the assurance of security, since Pyongyang's first requirement was a non-aggression guarantee from the United States.

The DPRK perspective on the 2002 nuclear crisis centred on the responsibility of the United States for causing another round of nuclear confrontation. Pyongyang judged that the Bush administration was the only party responsible for the cessation of the implementing process of the 1994 Agreed Framework. But at the same time, it did not rule out a possibility to cooperate with the ROK in the various subfields such as energy,

fertilizer, and rice. In the meantime, there was no critical incident or event which indicated deterioration in inter-Korean bilateral relations. After its arguable admission of the HEU program, it sought economic assistance and security assurance through an inter-state deal with the United States. Whereas the nuclear stalemate between the U.S and the DPRK strengthened hostile relations between the two nations, inter-Korean relations maintained a momentum at an appropriate level to gear up for post-crisis rapprochement. The ROK was the only party, from the perspective of the DPRK, which was prepared to give them economic assistance amid the mounting nuclear row.

#### *The ROK government perspective*

The Kim Dae Jung administration showed different policy initiatives from that of the Bush administration during the escalating military tension between Washington and Pyongyang. Kim Dae Jung had been a reluctant participant in the concerted pressure to confront the DPRK led by the United States since the outset of the crisis. He, for example, agreed to announce a joint statement with the United States and Japan deploring the DPRK in October 2002 at the Asia Pacific Economic Cooperation (APEC) meeting held in Mexico (*New York Times* 27<sup>th</sup> October 2002). However, he preferred in practice a more cautious stance toward the DPRK. As outgoing president, Kim urged the Bush administration to use patience and dialogue in dealing with its northern neighbor. He at the same time made an effort to maintain the momentum of the ever-growing reconciliatory mood created after the 2000 summit by describing Kim Jong Il as an intelligent and reliable negotiation partner (*New York Times* 25<sup>th</sup> January 2003).

Many policymakers in Seoul actually felt that Washington might have ‘misunderstood’, perhaps even deliberately distorted, what had been said in Pyongyang in terms of its secret nuclear program (McCormack 2004, 163). Also from the perspective of Roh Moo Hyun, who was elected as new South Korean president on 19<sup>th</sup> December 2002, the U.S. approach toward the DPRK was excessively coercive. It contradicted Roh Moo Hyun’s North Korea policy based broadly on the ‘Sunshine Policy’ of his predecessor (Park H.J. 2007, 14). In response to the admission of the North Korean HEU program, the hawkish group in the Bush administration began to examine the applicability of a ‘tailored containment’ strategy to enhance the isolation of the DPRK (*New York Times* 29<sup>th</sup> December 2002). But Roh Moo Hyun, the then president-elect, did not align himself with them. Instead, he was not hesitant to acknowledge that there existed differences of interest between traditional allies in dealing with Pyongyang (*Munhwa Ilbo* 1<sup>st</sup> January 2003).

Such diplomatic strains within the U.S. – ROK alliance after the outset of 2002 nuclear crisis deepened the perception gap between Washington and Seoul. In contrast to the U.S. skepticism on the effect of economic engagement with the Kim Jong Il regime, the ROK might well have believed that the increased inter-Korean interdependence would change the security environment in the Korean Peninsula. What Seoul envisioned was that the deepening economic, political, and cultural interdependence between the two Koreas would enhance in the end its leading role in dealing with Pyongyang. The DPRK however turned out to be unwilling to tackle the nuclear issue talking with the ROK. In fact, the North was not willing to accept the South as an influential negotiating counterpart in the nuclear deal. This suggested that

Seoul's increased interaction with the North had not contributed to ameliorating the security environment in the Korean Peninsula (Snyder 2005, 97). The stance of the ROK government, as a consequence, was in a dilemma over hammering out an appropriate option to simultaneously satisfy Washington and Pyongyang. At the same time, the ROK faced a growing concern that the future of inter-Korean economic cooperation might become bleak as a result of the increasing political and military tensions caused by the nuclear crisis. Even though the ROK was the closest neighbour of the DPRK with the most to lose if military tensions escalated to a physical conflict, it was not able to secure its seat on the negotiating table dealing with the nuclear program at least until six-party talks were launched in August 2003.

#### ***4.3 Increasing tension (2002-2006)***

This section will demonstrate the coexistence of the regional strain caused by the second nuclear crisis and the ongoing development of the cooperative projects at the inter-Korean level. Similar to the previous section, the positions of the individual parties involved will be examined to reveal the conflicts of interest between them.

##### *The US government perspective*

President Bush did not deem the DPRK a credible and legitimate interlocutor (Pollack 2003, 28). The Bush administration imposed a series of retaliatory measures against the DPRK immediately after the admission of its HEU program. KEDO, of which the United States was a leading member, decided to suspend the supply of heavy

fuel oil to the DPRK in November 2002 (KEDO 2002). The decision meant a significant change in the framework of the 1994 Accord, which committed the parties to provide energy aid in return for the freezing of nuclear facilities in the DPRK.

Since the terrorist attack of September 2001 in New York, the Bush administration has shown itself to be acutely concerned about the possibility of any WMD capabilities getting into terrorists' hands (Reese 2004, 250). In tackling the second nuclear crisis which erupted in 2002, American literature produced after September 11, focused on the likelihood of cross-border trade of nuclear material. Allison (2004, 73) argued that the United States should threaten to use all means, including military force, in case the DPRK did not declare verifiable abandonment of its nuclear weapons. Newman (2004, 77) argued that more international support would be needed to disarm the Kim Jong Il regime, beyond the current non-proliferation regime.

A military clash also became a possibility in dealing with this potential supplier or a trader of WMD in the highly turbulent Northeast Asia. The United States and two Spanish warships jointly intercepted and searched a cargo vessel flying no flag in the Gulf of Aden in December 2002. This vessel had been tracked by American intelligence all the way out from the DPRK. It was carrying North Korean Scud missiles to Yemen. American authorities however were forced to allow the weapons to be delivered to the planned destination because they lacked the necessary legal authority to seize the cargo by force (*New York Times* 11<sup>th</sup> December 2002). The United States imposed sanctions on the Changgwang Shinyong Corporation of North Korea for transferring missile technology to the Khan Research Laboratories in Pakistan in March 2003 (*New York*

*Times* 4<sup>th</sup> July 2003).<sup>32</sup> With a series of sanctions against the DPRK, the nuclear crisis in the Korean Peninsula escalated when it began to mesh with the broader U.S. foreign policy agenda aiming at the war on terrorism.

The Bush administration resumed a direct dialogue with Pyongyang in the wake of mediation by China in April 2003. Beijing invited both Washington and Pyongyang and hosted the trilateral talks aiming at a diplomatic solution of the nuclear stalemate. The trilateral talks took place amid the post-September 11 cooperation mood in the war on terrorism between China and the United States (Wu 2005, 35).

Multilateral dialogue seeking a diplomatic solution of the Korean nuclear crisis developed into six-party talks including Russia, Japan, and the ROK. The first meeting of the six-party talks was held in August 2003. A conclusion was reached in September 2005 that confirmed the DPRK's abandonment of all nuclear weapons and the existing nuclear programs. This 'September 19<sup>th</sup> Joint Statement' by six parties however did not mention the timing of dismantlement of the North's nuclear program. In return for the DPRK's commitment to forgo its nuclear program, the United States and other parties agreed to discuss, at an appropriate time, the DPRK's demand to receive LWRs (U.S. Department of State 2005). This joint statement failed to be implemented as the United States took a decision, shortly after the relevant parties signed this statement, to freeze the DPRK's bank account of Banco Delta Asia in the Macau Special Administrative Region in China. The U.S. Department of Treasury designated the Banco Delta Asia as a 'primary money laundering concern'. The U.S. treasury stated that this bank was related to the counterfeit and circulation of U.S. currency in working with the DPRK

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<sup>32</sup> For a further discussion on the Pakistan-North Korea nuclear and missile relationship, see Kampani (2002).

agency (U.S. Department of Treasury 2005). This U.S. action resulted in the DPRK's boycott of the six-party talks that had planned to discuss the implementation measures of the joint statement (Niksich 2006, 5). The continuous multilateral negotiations amid the U.S.-DPRK confrontation over the financial sanctions against the Banco Delta Asia in Macau failed to make any progress. The unresolved nuclear tension was further heightened as the DPRK conducted the first underground nuclear test in October 2006. It marked the most critical incident with which Pyongyang crossed the 'nuclear threshold' (O'Neil 2005, 317-18, Lee C.M. 2007, 15).

The United States pursued cooperative security stability in the Korean Peninsula with consent from China. The main vehicles in implementing this strategy were the three-party talks and the subsequent six-party talks. Intertwined vested and expected national interests, however, in a non-nuclear North Korea (Park 2005) caused more complicated and complex inter-state dynamics in Northeast Asia, 'one of the most volatile regions in the world' (Van Ness 2005). The target of analysis in scholarship was widened rather than deepened along the relevant state actors' interests and strategies surrounding the 2002 nuclear crisis (Laney and Shaplen 2003, Reese 2004). Scholarly analyses stressed the significance of multilateral engagement in ensuring military stability in the Korean Peninsula (Mauil and Harnisch 2002, Koo B.H. 2005, Kurata 2007, Funabashi 2007). This framework was useful in tackling the possibility of collective security assurance toward the DPRK. But it was also true that the overemphasis on multilateral negotiations militated against paying more attention to the internal dynamics, at various levels, between the two Koreas.

### *The DPRK government perspective*

The DPRK proclaimed that the 1994 Agreed Framework was in effect nullified after the Bush administration lifted the economic incentives committed in the Framework. As a result, Pyongyang carried out phased measures denying its obligation to implement the denuclearization stipulated in the Framework document. A month after KEDO's decision to suspend heavy oil supply to the DPRK (14<sup>th</sup> November 2002), the Ministry of Foreign Affairs announced that it would reopen the nuclear facilities that had been frozen under the Framework (*KCNA* 12<sup>th</sup> December 2002). The DPRK expelled the IAEA inspectors and removed the surveillance cameras monitoring its nuclear facilities.

In October 2003, the spokesman in the DPRK Ministry of Foreign Affairs made clear that the development of nuclear weapons was imminent by announcing the completion of the reprocessing procedure of the spent fuel rods. The DPRK officially declared its possession of nuclear weapons in February 2005. At the same time, the DPRK mission to the United Nations announced that they would no longer take part in the multilateral nuclear dialogues.

The DPRK and the United States continued to maintain opposing positions in the six-party talks (4<sup>th</sup> round) resumed in Beijing in July 2005. The DPRK demanded visible actions to restore confidence from the United States and the ROK, implying a peace treaty with the United States and abrogation of the ROK-U.S alliance. Other issues such as the North's right to use nuclear energy for a non-weapon purpose still remained unsettled. Nonetheless China as the nation chairing the six-party talks continued to attempt to narrow the perception gap between the DPRK and the United States. As a

consequence, the six parties agreed on the 'September 19<sup>th</sup> Joint Statement' in 2005. The DPRK committed in this declaration that it would abandon all nuclear weapons and existing nuclear programs. The United States, in response to the North's denuclearization plan, affirmed that it had no intention to attack or invade the North with nuclear or conventional weapons (Koo B.H. 2006, 93). However, as the DPRK angrily reacted to the U.S. action to intervene in its money transfer in the Macau Bank, the six-party talks faced another obstacle.

In July 2006, the United States intelligence confirmed that the DPRK had launched up to seven missiles including a Taepodong-2, three-stage intercontinental ballistic missile that had a range of 4,000 – 10,000 km (*New York Times* 5<sup>th</sup> July 2006). Although the Taepodong-2 failed within the first 40 seconds after launch, it was the first firing of a North Korean missile since the DPRK leadership declared the unilateral flight test moratorium in 1999.<sup>33</sup> Unlike the two short-range missiles test in 2003, this missile launch signalled a significant change in the DPRK's foreign policy on WMD (Kang 2003, 321).

The Korean Central News Agency (KCNA) announced, three months after the missile launch, that the DPRK conducted its first nuclear test on 9<sup>th</sup> October 2006 (*KCNA* 9<sup>th</sup> October 2006). The repeated warnings from Washington failed to deter Pyongyang from enforcing its previously declared nuclear test (*New York Times* 5<sup>th</sup> October 2006). The missile launch in July 2006 and the nuclear test three months later created a watershed in the inter-state standoff derived from the Kelly-Kang Sok Ju

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<sup>33</sup> It was debatable to judge whether the North Korean launching of Taepodong-2 was a direct violation of this moratorium. North Korea agreed on unilateral suspension of ballistic missile firing in 1999 with the condition of 'as long as the US and the DPRK were engaged in negotiations' to improve bilateral relations. For more detailed discussion, see Pinkston (2008).

meeting in October 2002. As a consequence, despite several multilateral talks to settle the standoff, the security instability in the Korean Peninsula between 2002 and 2006 has been deepened and widened.

### *The ROK government perspective*

The North Korean HEU program was revealed amid an increasing mood of inter-Korean reconciliation and cooperation. Reflecting this mood of thaw, the ROK's response to the revelation of the HEU program was ambivalent in terms of the issue of policy choice toward the DPRK. The ROK government, on the one hand, closely cooperated with the United States and Japan through the Trilateral Coordination and Oversight Group (TCOG) to dissuade the DPRK from restarting the Yongbyon nuclear reactor. Seoul echoed Washington's stance demanding a 'complete, verifiable, and irreversible' dismantlement of the North's nuclear facilities as a precondition for resuming talks with the DPRK (*New York Times* 8<sup>th</sup> January 2003). In domestic politics in Seoul, however, key South Korean policymakers voiced matters differently. President Kim Dae Jung consistently stressed the settlement of the nuclear confrontation only through a diplomatic and peaceful dialogue between the involved nations. The Kim Dae Jung administration made every effort to broker a dialogue between Washington and Pyongyang, persuading the two parties not to cross each other's red lines (Son K.Y. 2005, 155).

The then president-elect Roh Moo Hyun also publicly opposed sanctions against the DPRK through the United Nations resolution (*Chosun Ilbo* 1<sup>st</sup> February 2003). More

importantly, Roh Moo Hyun's continued economic engagement policy with the DPRK throughout his term and its achievements coincided with the Bush administration's unchanged coercive line toward Pyongyang in his second term. Although Roh Moo Hyun and Bush in their summit held in November 2005 declared that they would never tolerate a nuclear armed North Korea, the subtext of 'non-tolerance' was interpreted differently. One American observer wrote,

In the weeks leading up to President Bush's arrival in South Korea, the Roh government engaged in a continuing debate about whether to double its aid to North Korea next year and pour nearly 2.5 billion USD into the country. The Bush administration is heading in exactly the opposite direction. For months, it has been working behind the scenes to cut off as many of North Korea's sources of revenue as it can (*New York Times* 18<sup>th</sup> November 2005).

One of the demanding tasks for the Roh Moo Hyun administration was to cope with the pressure from Washington that insisted on suspension of the joint production in the KIC and of the Mount Kumkang tourism project after the North Korean nuclear test (Park H.J. 2006, 16-17). For example, President Bush's Special Envoy for Human Rights in North Korea, Jay Lefkowitz openly condemned that Kaeseong Project might simply end up providing funds propping up the North Korean regime and demanded it should be discontinued (*Yonhapnews* 11<sup>th</sup> November 2006).

However, the Roh Moo Hyun administration all along maintained a relatively conciliatory attitude toward the DPRK. Even during the rising confrontation between

Washington and Pyongyang, the administration dispatched a special envoy to the North (June 2005) soon after the DPRK Foreign Ministry officially declared its possession of nuclear weapons. As a result, despite the security instability caused by the nuclear standoff, inter-Korean meetings to discuss various cooperative projects continued between 2002 and 2006. Around twenty to thirty meetings per annum in this period took place in various subfields ranging from military affairs to inter-Korean railway reconnection projects (MOU 2006). The South Korean government did not want the situation in which the nuclear confrontation between the United States and the DPRK destroyed the achievements of the inter-Korean cooperative dialogue since 2000 (Levin and Han 2002). Seoul, on the other hand, believed that its continued engagement attempts with the North Korean actors, at both state and sub-state levels, promoted substantial changes in the security environment in the Korean Peninsula. In this sense, inter-Korean relations in this period were placed on a different track in terms of the actors and dynamics from that of the United States and the DPRK.

#### ***4.4 Inter-Korean trade***

This section will discuss the contribution of commercial trade in deepening and widening interdependence between the two Koreas. It will then show that the POC-based inter-Korean trade including the KIC projects provided both parties with more beneficial conditions to strengthen economic interdependence. The majority of the ROK firms that took part in the trade with the DPRK did not show a surplus in their balance sheet. The survey result quoted in this section, however, showed that they did not accept their inter-Korean business as an utter failure. By providing a variety of statistics

showing a key feature of stable growth in inter-Korean trade during the nuclear crisis from 2002 to 2006, this section will argue two points. One is the fact that commercial trade became an increasingly dominant pattern in inter-Korean trade in the Roh Moo Hyun administration. The other is that short-term profitability was not the only variable for ROK business actors to make a decision whether to engage with the DPRK or not.

### *Trend of inter-Korean trade*

The Roh Tae Woo administration (1988-1992) created a legal guideline on inter-Korean economic exchange for the first time after the end of the Cold War. The administration announced a set of subsequent policy initiatives to promote it. It was the first nuclear crisis to block the progress of any attempt for the inter-Korean economic exchange set up by the Roh administration. The DPRK declaration to withdraw from the NPT in 1992 triggered the first nuclear crisis. As table 4.2 shows, inter-Korean trade volumes marginally increased (4-8%) from 1992 to 1994 when the first nuclear crisis prevailed. The Agreed Framework between the DPRK and the United States in 1994 eliminated the nuclear tension at least temporarily. The inter-Korean trade volume in 1995 recorded a dramatic increase (48%) as a result of the removal of the political uncertainty and in turn the rice aid towards North Korea (150,000 ton) decided by Kim Young Sam. It consequently showed a considerable linkage between the political environment and the economic interaction. In other words, the economic interaction between the two hostile actors could not be viable without the backing of political stability.

Table 4.1 Inter-Korean trade volume (1989-2007)

(Unit for volume : 1,000 USD)

Year	North to South			South to North			Sum		
	Cases	Items	Volume	Cases	Items	Volume	Cases	Items	Volume
1989	66	24	18,655	1	1	69	67	25	18,724
1990	79	23	12,278	4	3	1,188	83	26	13,466
1991	300	43	105,719	-	16	5,547	300	57	111,266
1992	510	69	162,863	62	25	10,563	572	92	173,426
1993	601	69	178,167	97	37	8,425	698	103	186,592
1994	708	80	176,298	267	87	18,249	975	158	194,547
1995	976	109	222,855	1,668	167	64,436	2,644	244	287,291
1996	1,475	130	182,400	1,908	167	69,639	3,383	258	252,039
1997	1,808	143	193,069	2,185	284	115,270	3,991	365	308,339
1998	1,963	136	92,264	2,847	379	129,679	4,810	449	221,943
1999	3,089	172	121,604	3,421	405	211,832	6,510	488	333,437
2000	3,952	204	152,373	3,442	527	272,775	7,394	578	425,148
2001	4,720	201	176,170	3,034	492	226,787	7,754	549	402,957
2002	5,023	204	271,575	3,773	495	370,155	8,796	572	641,730
2003	6,356	186	289,252	4,853	530	434,965	11,209	588	724,217
2004	5,940	202	258,039	6,953	575	439,001	12,893	634	697,040
2005	9,337	381	340,281	11,878	712	715,472	21,215	775	1,055,754
2006	16,412	421	519,539	17,039	697	830,200	33,451	757	1,349,739
2007			765,346			1,032,550		853	1,797,896
2008			932,654			888,987		859	1,820,986

Source : MOU (2008)

Table 4.2 Number of participating companies in inter-Korean trade

Year	91	92	93	94	95	96	97	98	99	00	01	02	03	04	05	06	07
Tota	56	77	121	136	236	319	356	419	516	536	506	432	481	462	523	477	425
POC	4	12	11	24	70	64	66	131	157	147	108	109	118	136	153	130	

Source : MOU (2008)

However, the overall trend in inter-Korean trade from 2002 to 2006 (second nuclear crisis) demonstrated a remarkably different picture from the first crisis. Inter-Korean trade during this period largely continued to grow without significant decline. In 2002, for example, the total volume of inter-Korean trade was 641 million USD but it reached 1.3 billion USD in 2006 showing a big increase of 110%. Transaction items

were diversified involving a variety of manufacturers and traders. The number of items carried in and out in 2002 was 572 but it reached 757 in 2006. What is more, the overall growth of inter-Korean trade during the second nuclear crisis was also much faster than that of the first crisis in the 1990s.

The trend of inter-Korean trade in 2006, as Pyongyang greatly heightened inter-Korean tension by firing a long-range missile and conducting a nuclear test, shows a clearer picture as to whether and how much the nuclear crisis affected inter-Korean trade. Although the degree of increase in inter-Korean trade in comparison with the previous year did not reach that of 2005 (52%), trade volume in 2006 saw a greater degree of increase in inter-Korean commercial trade (35%) than non-commercial trade (15%). The joint manufacturing projects in the KIC recorded a 69% increase and other economic cooperation projects were saw 149% up in comparison with 2005. The launch of the joint production projects and construction of manufacturing factories on North Korean soil especially led to great quantities of South Korean materials being moved into the North Korean territory. The materials mainly included heavy construction equipment, production facilities, parts and raw materials for on-site production in the KIC. Unlike the still vibrant commercial trade in 2006, non-commercial trade saw little progress especially in the second half of 2006 due to the nuclear confrontation (KITA 2007). These meant that even though non-commercial trade (humanitarian aid, socio-cultural projects etc.) was heavily affected by the nuclear crisis, its influence on commercial transactions was fairly limited.

The only exception to increased inter-Korean trade between 2002 and 2006 was 2004 when the imports from the DPRK decreased by 10.8% compared with the previous

year. But two non-political factors could explain this temporary decline. Firstly, it was the result of the ROK government's regulation to reduce the influx of agricultural and fishery products to protect domestic suppliers/producers. Secondly, the stagnation of domestic consumption in the ROK subsequently caused low demand for POC production in the DPRK (MOU 2005, 86). All in all, it was clear that neither case provided any evidence to show a direct and specific impact of the nuclear crisis on inter-Korean trade.

The result of the survey research conducted in the ROK also demonstrated a similar pattern of discrepancy between how the South Korean business actors perceived the influence of the nuclear crisis and how much they consequently reduced their trade volume with North Korea. Whereas 58% of the South Korean companies who took part in the survey answered that the military tension caused by the second nuclear crisis affected their business (Figure 4.1), only 27% of the total respondents turned out to decrease their inter-Korean trade volume from 2002 to 2006 as a result. On the other hand, 42% of the respondents increased their trade volume despite the unstable political environment during the crisis. 31% of them answered that they neither increased nor decreased the trade volume during the period (Figure 4.2).

Figure 4.1 To what extent, has your inter-Korean trade been affected by a series of security instabilities caused by the North Korean nuclear program which was revealed in 2002?

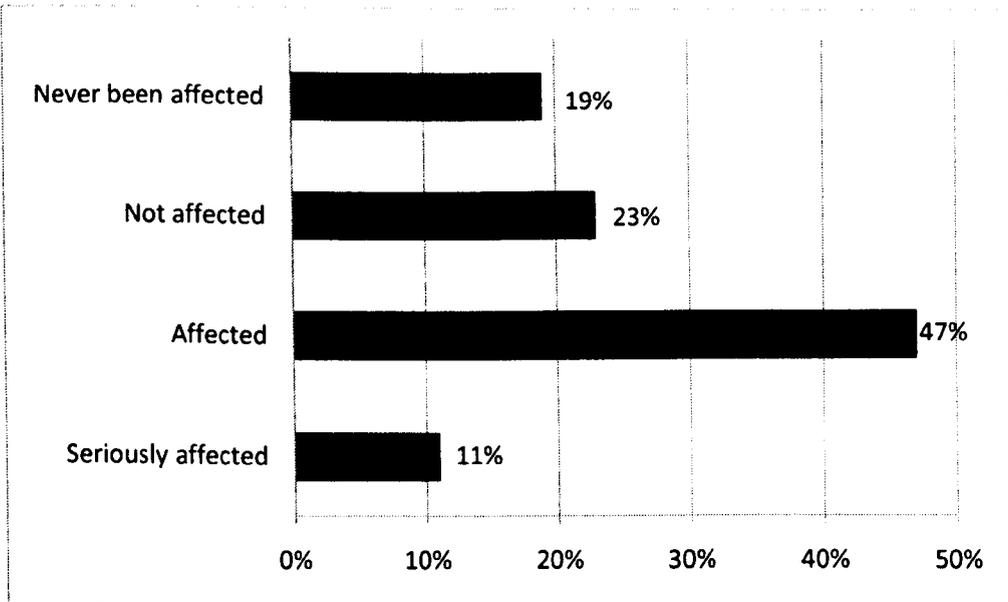
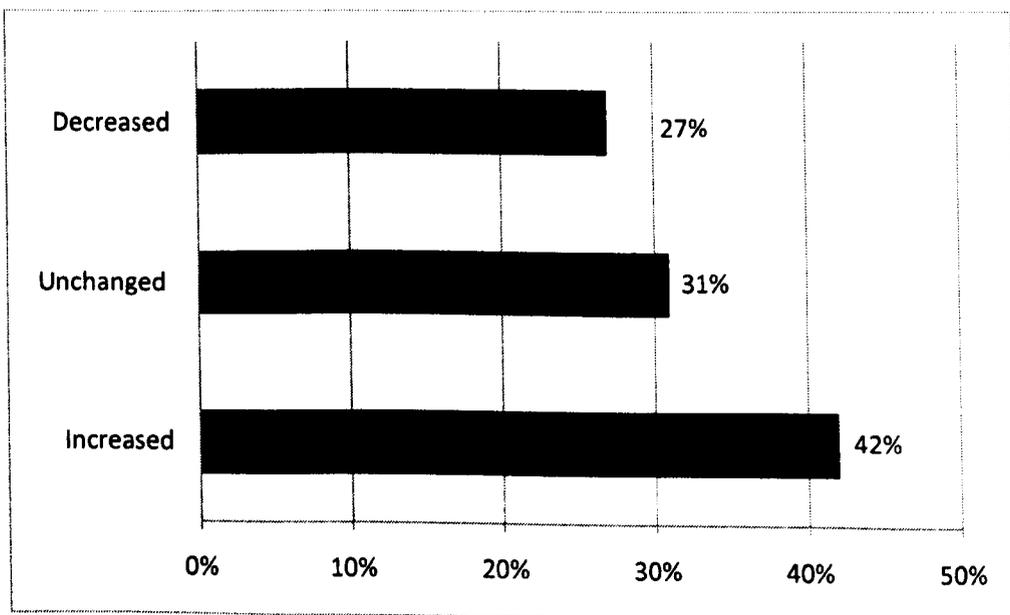


Figure 4.2 Did the volume of your trade with the DPRK change between 2002 and 2006?



This result showed a consistency with the other survey results conducted in November 2002 and May 2003 respectively to see the change in perception of South Korean entrepreneurs viewing the influence of the second nuclear crisis. The Korea Development Institute (KDI), the ROK government-run research institute, separately asked the experts group on the North Korean issues and the entrepreneurs group actually involved in inter-Korean business how they perceived the influence of the second nuclear crisis.<sup>34</sup> In the 2002 survey conducted immediately after the North's admission of the alleged nuclear program, the overwhelming majority of the experts (88%) and entrepreneurs (72%) expressed great concern about the influence of the nuclear crisis on inter-Korean trade. In the subsequent 2003 survey conducted six months later, however, only 37% of the entrepreneurs responded with expressed concern about the negative influence of the nuclear crisis. In the wake of the removal of the anxiety, the majority of South Korean entrepreneurs (62%), according to the survey, did not adjust the volume of the inter-Korean business as a consequence of the outbreak of the second nuclear crisis. Given the fact that 82% of the experts group still had a negative view in the 2003 survey, the entrepreneurs' changed perception implied that the initial anxiety was considerably eased. As these surveys illustrated, the nuclear crisis-driven security threat in the Peninsula did not undermine the continued economic engagement between the two Koreas. The tense political relationship, in other words, caused by the possibility of

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<sup>34</sup> The Korea Development Institute (KDI) has conducted this periodical survey every six months since 2001 to acquire data from the ROK business community involved in the inter-Korean trade. This shows the result of the time-series analyses on the various factors that affected the decision making surrounding the inter-Korean trade.

military conflict did not dampen the existing economic interdependence they had achieved over the previous decade.

Observation focusing on commercial trade shows more active engagement of the South Korean business community in inter-Korean cooperation projects. Whereas non-commercial trade showed a modest growth (46%) from 2002 to 2006, commercial trade showed an even more significant increase (162%) in the same period. As Table 4.3 shows, the continued growth of commercial trade from 2002 to 2006, led largely by the joint production projects in the KIC, resulted in making it the dominant pattern of inter-Korean trade in spite of the nuclear crisis.

Table 4.3 Inter-Korean commercial transaction volume

	(Unit : million USD, Percent)									
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Commercial Transactions	256 (60.2)	244 (60.6)	355 (55.3)	425 (58.7)	437 (62.7)	690 (65.3)	930 (68.9)	1,431 (79.6)	1,712 (94.0)	1,643 (97.8)
Non-commercial Transactions	169 (39.8)	159 (39.4)	287 (44.7)	299 (41.3)	260 (37.3)	366 (34.7)	420 (31.1)	367 (20.4)	108 (6.0)	37 (2.2)
Total	425	403	642	724	697	1,056	1,350	1,798	1,820	1,679

Note : Figures in brackets represent percentage shares in total inter-Korean trade

Source : KITA (2008)

Table 4.4 Commercial transactions by sub-category

(Unit : million USD. Percent)

	2000	2001	2002	2003	2004	2005	2006	2007 <sup>35</sup>	2008	2009
General Trade	111 (43.4)	111 (45.5)	171 (48.2)	223 (52.5)	171 (39.1)	210 (30.4)	304 (32.8)	461 (32.2)	399 (21.9)	256 (15.3)
POC Trade	129 (50.4)	125 (51.2)	171 (48.2)	185 (43.5)	176 (40.3)	210 (30.4)	253 (27.3)	330 (23.1)	408 (22.4)	410 (24.4)
KIC Projects	0 (0.0)	0 (0.0)	0 (0.0)	0 (0.0)	42 (9.6)	177 (25.7)	299 (32.3)	441 (30.8)	808 (44.4)	941 (56.0)
Other Economic Cooperation Projects	16 (6.3)	8 (3.3)	13 (3.7)	17 (4.0)	48 (11.0)	93 (13.5)	73 (7.9)	199 (13.9)	96 (5.3)	36 (2.1)
Total	256	244	355	425	437	690	928	1,431	1,712	1,643

Note : Figures in brackets represent percentage shares in total inter-Korean commercial trade  
Source : KITA (2008)

Apart from these quantitative data, the real experience of South Korean entrepreneurs also suggested that no serious decline in inter-Korean trade was made after the eruption of the nuclear crisis. The case of the South Korean apparel manufacturer, Shinwon that has been running a POC production facility in Pyongyang (since 1994) and Kaeseong (since 2004) shows that they maintained the same level capacity and volume of business in the DPRK during the second nuclear crisis all along. The chief executive Park Heung Shik (2008) stated,

Counting the rising domestic consumer demand in South Korea with the recovery of the IMF crisis, we arranged a contingency plan in 2002 that could replace the volume that had been producing in Pyongyang in case of likely further exacerbation of security. But no action was taken from either

<sup>35</sup> The figures in 2007 and 2008 include another sub-category created by inter-Korean agreement to swap South Korean light industry material and North Korean minerals (zinc, magnesite). The ROK and the DPRK reached this agreement in July 2004 and the first export of the South Korean material commenced in July 2007. From that time on, result of light industry cooperation projects was separately compiled within the commercial trade category. But, in table 4.4, this figure is simply included in the 'other economic cooperation projects' for consistency with the previous years. This can explain the dropping percentage share of the production in the KIC despite its continued growth in 2007.

side to affect the normal two-way shipment of production materials and completed goods.

Although psychology and mood were affected by external security turbulence, as long as the supply-production-payment-sale chain in the POC process continues as it used to, entrepreneurs detected no perceptible danger to their business from the insecurity. Park Heung Shik pointed out competitive prices, quality of goods produced, and delivery date as key elements affecting their investment decisions regardless of external political conditions. Yet according to his experience there was no sign of North Korean trade officials neglecting these duties or putting existing inter-Korean trade into a political frame in the wake of the rising disputes between the South and North authorities. What he witnessed was rather the opposite.

North Korean trade officials seemed fairly anxious about the possibility of decline or suspension of inter-Korean trade that might come from political instability after the nuclear crisis. They kept cautiously asking us about the outlook of inter-Korean trade as the security crisis had developed and refrained from mentioning North Korean state media's propaganda on the nuclear problem. They all along stressed that inter-Korean trade must be sustained and that they had no intention to suspend it even under the nuclear crisis.

South Korean businessmen who have been running POC factories in the DPRK actually felt the North Korean trade officials' attitude change while the nuclear crisis was being developed in comparison with the 1990s. According to Park Heung Shik, they showed South Korean counterparts greater power and capacity at each level of decisions making ranging from wages to quality control, which they could hardly obtain in the 1990s. They became more cooperative and showed a more active approach in improving a variety of conditions surrounding the POC production.

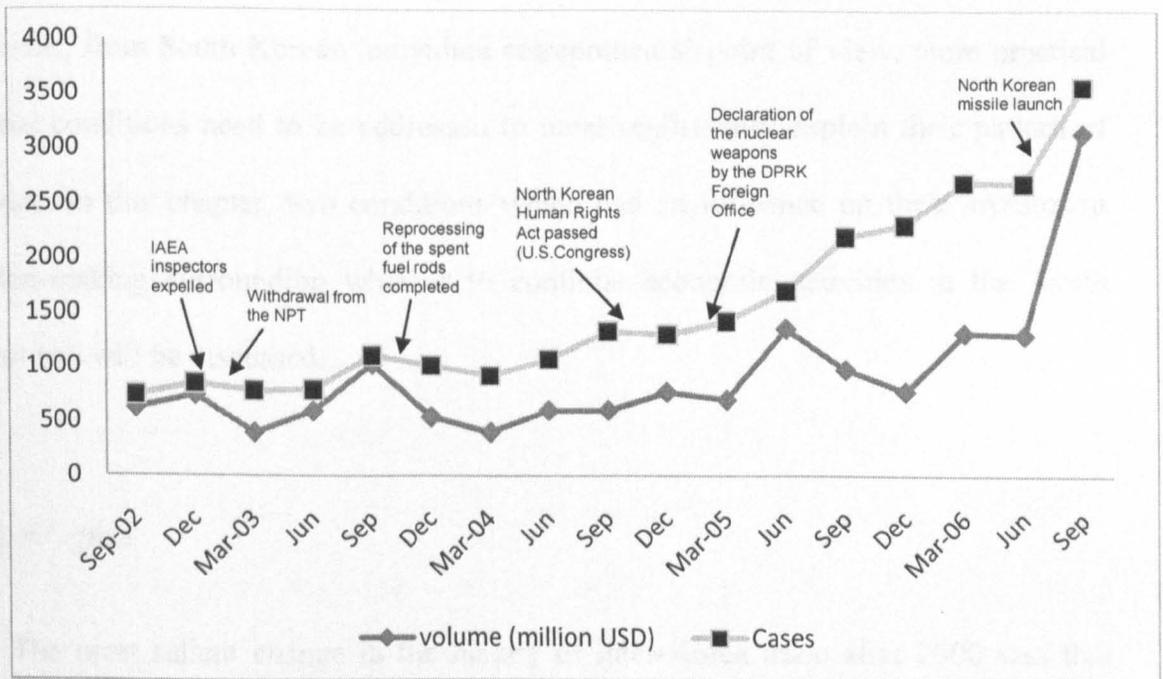
Another South Korean businessman Yu Wan Young (2008), who has been running a computer monitor factory in Pyongyang since 1998, stated that he could detect a more amenable attitude of the North Korean trade officials as the nuclear crisis heightened.

In case the South Korean trade partners are about to make a decision to delay the planned investment, due mainly to the gloomy economic outlook under the nuclear crisis, the North Korean people tended to offer more favourable transaction conditions. They proposed, for example, to make a payment in cash instead of paying in kind and to reduce the processing cost in their factory. They tended to pay more attention to quality management and a strict delivery date under the crisis. The crisis made our voice stronger and their voice weaker.

One needed to note that all these improvements and changes happened in parallel with mounting military tension caused by the second nuclear crisis. Figure 4.3 shows

these simultaneous events in a graph, suggesting the North Korean attempts to ratchet up pressure on its counterparts in the nuclear deal continued all along between 2002 and 2006. As this graph shows, the heightening tension in terms of the nuclear crisis failed to reverse the growth of inter-Korean trade.

Figure 4.3 Inter-Korean trade after the outbreak of the nuclear crisis (2002-2006)



Source : MOU (2002-2006)

As discussed in chapter 3, it was the Kim Dae Jung administration's new North Korea policy initiatives such as '*Jongkyong Bulli*' and 'multiple channel policy' that laid a foundation upon which the South Korean business community was able to constantly engage with North Korea during the crisis. His predecessor, Roh Moo Hyun subsequently made efforts to strengthen the infrastructure of inter-Korean economic relations. For one example, he made an agreement with the North on maritime issues by which the two Koreas opened new sea routes and the South allowed North Korean

vessels to transit through its own territorial waters. This maritime accord brought about a remarkable improvement in the logistics of inter-Korean trade.

Ten years' continued pursuit of economic engagement policy consolidated the foundation of inter-Korean economic cooperation and created the most favorable conditions ever for inter-Korean trade as a result. However, apart from these external conditions, from South Korean individual entrepreneurs' point of view, more practical business conditions need to be addressed to more realistically explain their pattern of behavior. In this chapter, two conditions which had an influence on their investment decision-making surrounding whether to continue economic activities in the North Korean soil will be discussed.

#### *'Lock-in' effect*

The most salient change in the history of inter-Korea trade after 2000 was that shares of POC trade and economic cooperation projects dramatically increased in comparison with general trade. Excluding non-commercial trade such as humanitarian aid, the share of economic cooperation projects within the commercial trade category grew from 6.3% in 2000 to 44.7% in 2007. The volume of POC trade has also maintained a higher level than the general trade since 2000 (KITA 2008). General trade was largely contingent upon the industrial capacity of the DPRK. In the 1990s, the overwhelming majority of goods transported from the North to the South were minerals and nonferrous metals such as zinc nodules. Agricultural and marine products such as clams, dried fish products, and mushrooms formed the second largest element of total

exports from the North to the South. This export pattern clearly showed the North Korean domestic industrial structure still heavily dependent upon agriculture and the mining industry.

The decline of general trade thus implied the fact that the DPRK industry failed to supply enough consumer goods to be exported. The shortage of DPRK industrial production caused stagnation in general trade. POC trade on the other hand was not necessarily affected by the lack of the supply capability of the DPRK domestic industry. POC trade was rather able to make a contribution to reinvigorate the old and non-operational production facilities in the DPRK (Lee J.K. 2002, 43-48).

On the ROK side, a number of firms particularly in light industry such as apparel and footwear manufacturing were looking for new production sites overseas. This was due to increasingly high costs in the domestic labor and land markets. The ROK entrepreneurs considered POC-based manufacturing in the DPRK a viable alternative that could replace production in China and Vietnam.<sup>36</sup> The geographical proximity and the use of common language were the main benefits for the ROK entrepreneurs to prefer economic activities in the DPRK. The ROK government, in addition, granted a set of extra preferential benefits to the participant firms in the POC trade. The primary measure was exemption from the 15% customs duty which otherwise they should have paid. This meant that POC trade could become the increasingly viable trade pattern which would bring mutual benefit to both Korean industries (Lee J.K. 2002, 39-43).

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<sup>36</sup> The chief manager of the one of the biggest tenant firms in the KIC, for example, stated that the labor cost in Kaeseong is twenty times lower than that of the ROK. The labor cost of the KIC was half that of Shenzhen in China, one of the popular production sites for South Korean SMEs, according to him (*The Hankyoreh*, 9<sup>th</sup> January 2005).

The more important feature of the POC trade in terms of the improvement of inter-Korean relations was the prior discussion and negotiation it essentially required before both parties embarked on actual joint production. POC trade, in nature, required more complex and complicated preparation procedures than general trade (Lee J.K. 2002, 39). It needed a long period of mutual negotiation and face-to-face communication before and after launching the joint business. POC trade required the presence of a quality controller, for example, in order for the manufacturer to maintain a uniform level of product quality. The quality controller's paramount mission was to overhaul the quality standards the manufacturer has been required to meet. The DPRK authority responded to the necessity to promote POC trade by enacting the 'Processing Trade Act' in 2001 (*Chosun Ilbo* 22<sup>th</sup> November 2001). Pyongyang, under this new legislation, officially recognized a new pattern of trade and permitted on-site stationing of a quality controller from an external institution. This particular provision, however, was not applied to the trade with ROK counterparts (Lee J.K. 2002, 54). The fact, nevertheless, should not be underestimated that the frequent prior negotiations between the two Koreas for the POC trade deepened their interdependence. It also showed the DPRK's more flexible attitude on the quality control of their products by external actors.

The utilization of the non-operational facilities and the influx of hard currency were not the only benefit of POC trade that the DPRK received. POC trade also needed collaboration with South Korean technical experts. This opportunity brought about another contribution for the DPRK workforce through the enhancement of manufacturing technology and skill. Helper et al. (2000) and Whitford and Zeitlin (2004) called this process 'learning by monitoring'. On the ROK side, POC trade

brought more benefit than general trade to the small and medium sized entrepreneurs. According to the Korea International Trade Association (KITA), average turnover per firm in POC trade (as of 2005) was three times higher than in general trade (KITA 2006). From 1993 to 2004, POC trade showed rapid growth of 24.5 % every year on average (Kim Y.Y. 2005, 17).

Table 4.5 POC and general trade (2000-2006)

		(Unit : 1,000 USD)						
		2000	2001	2002	2003	2004	2005	2006
General Trade	Number of firms	386	369	333	380	364	379	
	Turnover	110,529	111,389	171,782	223,670	171,324	209,778	
	Turnover per firm	286	302	516	589	471	554	
POC	Number of firms	157	147	108	109	117	136	123
	Turnover	129,190	124,924	171,177	185,009	175,959	209,729	
	Turnover per firm	823	850	1,585	1,697	1,504	1,542	

Source : KITA (2006) MOU (2007) p.43

The relative preference for POC trade however could not completely remove the unforeseeable risk the inter-Korean trade faced. It was particularly true in the event the communication channel between the business partners became temporarily disconnected as a result of unexpected external conditions. As the second nuclear crisis erupted in 2002, serious anxiety among ROK manufacturers began to spread. They were deeply concerned that they might have no more opportunities to continue their business in the DPRK in the wake of the recurrence of nuclear crisis in the Korean Peninsula. The result however showed that very little POC production was interrupted. The ROK government was extremely reluctant to take any action to suspend developing inter-Korean POC trade even under the growing military strain. This was because South Korean raw materials, intermediate goods, and parts already sent to the North were being kept in

North Korea. South Korean manufacturers were not allowed to access these assets without permission from the North Korean relevant authority. The lack of accessibility to South Korean material in the North Korean territory under the political instability, from the viewpoint of South Korean business, was likely to cause unavoidable economic cost (Lee J.K. 2002, 33-38). Due to such a situation, the vast majority of South Korean enterprises that had sent North Korea semi-processed or raw materials, and intermediate goods were strongly motivated to continue their business in the North even during continued political instability. POC-type production in the North was also backed up by the South government. Having pointed out limitations of general trade being carried out without any presence of South Korean people in the North, the government signalled more incentives would be given to POC-type projects entailing cross-border move of resources, along with the joint production projects in the KIC (MOU 2005). As a result, the South Korean government as well as business community tended to treat such large scale, cross-border investment in the DPRK as an upgraded model of inter-Korean trade.

The changed pattern of inter-Korean transactions after 2000, in this sense, created what this study will dub the 'lock-in' effect. The effect in this study refers to a consequence that was brought about by economic interdependence, built on production activities in each other's territory, between two hostile actors in which rising political clash failed to stop joint production. Mutually credible commitments for constant economic cooperation and subsequent legislation and its enforcement are the main factors that made the 'lock-in' effect workable. On the other hand, the effect provided a more stable condition for future cooperation between the two hostile actors by raising the cost of non-cooperation or non-compliance with the relevant legislation. This liberal

finding led states to the situation where the higher the interdependence that the states accomplished, the more they tended to avoid resorting to violent resolution of disputes. The effect as a result led to induce actors from both sides not to completely sever economic relationships that had developed over the last decade even though the political climate became confrontational again. This effect showed grounds for challenging the argument that the economic exchange had no bearing on the political relationship.

The new pattern of inter-Korean trade in this period facilitated and further solidified the direct contact of the relevant actors between the South and the North. As a consequence of the 'lock-in' effect, any attempt to reverse the existing course of actions in inter-Korean trade was becoming either impossible or extremely costly. Under the Lee Myung-bak administration that took office in 2008, the nuclear negotiations faced a deadlock that resulted in the advent of Cold War-style confrontation. However, when it came to inter-Korean economic collaboration, the KIC projects that employed more than 40,000 North Korean workers were not critically affected due to the catastrophic outcome that a shutdown of this complex was likely to bring about. Unlike these joint production projects, the Mount Kumkang tourism program has been suspended all along since one South Korean woman on tour to the mountain was shot to death by North Korean military guards in 2008. The continuity of the KIC project and the suspension of the tourism project offered examples of how the 'lock-in' effect was likely to contribute to maintaining the driving force of inter-Korean economic cooperation.

The effect consequently resulted in the ROK transnational actors' continuous engagement with the DPRK despite the security instability at the state level. Keohane earlier commented that 'sequentially occurred' reciprocal exchanges promoted more

solid and sustainable cooperation rather than 'simultaneous' ones (Keohane 1986, 21-22). The 'lock-in' effect in inter-Korean trade clearly supported his argument. The effect at the same time constituted one of the factors to insulate the inter-Korean economic engagement from the influence of the volatile and the fragile security situation in the Korean Peninsula. The other factor that ensured the continuity of inter-Korean trade under the military insecurity came from the perception of the South Korean traders on how to judge success or failure of the trade. The next section will discuss this issue.

### *Success or failure ?*

The net balance of the inter-Korean commercial trade showed that the ROK side recorded a continued and considerable deficit. However, the ROK business actors did not come to the conclusion that the trade with the DPRK was a total failure for this reason. The South Korean business community of SMEs rather paid more attention to the learning effect from inter-Korean trade they acquired and likely improvement of the situation in the future relationship.

Although the ROK began to produce a surplus through trade with the DPRK from 1998, it was true only when taking non-commercial trade into account. The nominal surplus in this statistics mainly came from the supply of humanitarian aid material to the DPRK and the KEDO projects including heavy fuel oil supplies and the support of construction materials for LWRs. For example, humanitarian assistance, LWR materials transfer to the DPRK accounted for 93% of total export volume from the South to the North in 2003. While the ROK side produced a 145 million USD surplus in total trade

balance in this year, the net balance in commercial trade recorded a deficit of 170 million USD. Furthermore, the gap between the total inter-Korean trade balance and the balance in commercial trade has increased, showing a mounting flow of goods for humanitarian aid and infrastructure construction projects in the North, since 1998 (Kim Y.Y.2005, 8-9).

The lack of profitability in inter-Korean trade provoked a skeptical view on the continuity of the inter-Korean economic engagements (Noland 2000, Cho D.H.2003). Tait, for example, analyzed six South Korean trade firms' cases and concluded that the failure was structural and unavoidable. He then argued that the POC trade with the DPRK had a minuscule impact on the opening of the North Korean economy (Tait 2003, 321-23). Others also pointed out the lack of stability and profitability as the main obstacles to the ROK SMEs' long-term engagement with the DPRK (Yoon D.K. and Yang M.S. 2005, 15-16).

The short-term loss or the insufficient profit, however, did not necessarily lead to a discontinuity in inter-Korean trade in the long run. The result of a survey conducted in 2001 by the Korea Development Institute (KDI), a government-run research agency, showed this discrepancy. Half of those who responded in this survey acknowledged that their motivations to continue the business with DPRK were unrelated to profit generation (Tait 2003, 312). Another survey titled 'The study of failure cases in the inter-Korean economic cooperation' by Kim Young Yoon (2004) raised significant implications for how to define 'success' and 'failure' in inter-Korean trade. He conducted a structured survey of about thirty South Korean SMEs involved in inter-Korean trade. According to this survey, 63.4% of the respondents recorded a financial

deficit through their trade with the DPRK counterparts. Only 16.7% of the respondents answered that they reaped an economic profit from inter-Korean business. 20% answered that they were around a break-even point. Unlike the ROK SMEs' profit and loss assessment, however, their criterion dividing success and failure in inter-Korean trade showed a different perception. The respondents who assessed their inter-Korean trade as a failure were no more than 40%. Nearly half of the respondents concluded that the attempts for the inter-Korean economic engagement were successful despite low profit expectations.

The conclusion of this survey was that the ROK business community showed a strong proclivity not to label inter-Korean business as a failure even if it failed to turn a profit. When asked why they defined inter-Korean trade as a success, less than half pointed out the profit they reaped through the trade. More than half, on the contrary, indicated either 'the expectation of a profit in the future' (28.6%) or 'the acquisition of lessons and experiences through inter-Korean trade' (28.6%). Kim Young Yoon stated that ;

Inter-Korean trade, particularly the POC based trade, was carried out on the basis of an economic approach aiming at mutual benefit. Whereas the ROK business community needed a new production site overseas, the DPRK had no choice but to accept the offer from its Southern neighbour. The DPRK's action was a means to overcome the shortfall of foreign currency caused by the economic recession (Kim Y.Y. 2005, 57-58).

It would be misleading, as shown above, to exclusively consider short-term profitability as the only variable in tackling the viability of the inter-Korean trade. The perception of the ROK business actors expecting the potential of the inter-Korean trade laid the groundwork to understand the stable growth of trade volumes from 2002 to 2006 as the second nuclear crisis peaked.

#### **4.5 Conclusion**

This chapter demonstrated heightened tension in the Korean Peninsula and beyond driven by the second nuclear crisis from 2002 to 2006 and contrasted it with the ongoing development of inter-Korean trade. The trade statistics, from 2002 to 2006 when the crisis peaked with the North Korean missile launch and nuclear test, showed stable growth despite the mounting security tension during this period. What was more salient was relatively rapid growth of commercial trade and large investment projects led by the South Korean business community. This particular sector of inter-Korean trade showed that the ROK business community was convinced to more actively engage with the DPRK expecting more vibrant development of inter-Korean trade during or after the nuclear crisis.

Key factors that convinced the South Korean business community to have positive prospect regarding the future of inter-Korean trade were the South Korean government's policy line summarized by the '*Jongkyong Bulli*' and 'multiple channel policy'. These two policy initiatives proposed by Kim Dae Jung and subsequently supported by Roh Moo Hyun offered a foundation upon which the ROK business actors increased economic engagement with the DPRK even under the nuclear crisis.

A strong issue hierarchy dominated by the DPRK nuclear program seemed to exist between 2002 and 2006 as the tit-for-tat style confrontation between the United States and the DPRK continued to grow. However, continued efforts by the ROK government to maintain inter-Korean exchanges at the non-security agenda made it possible for South Korean entrepreneurs to overcome the seemingly security-dominated environment of inter-Korean relations during the crisis. The stable growth of inter-Korean economic engagement expedited by the '*Jongkyong Bulli*' also suggested the actual issue areas based on hierarchical order in the inter-Korean relations were significantly dampened by the growing interdependence.

This meant that the security instability did not weaken the inter-Korean interdependence but strengthened it under the influence of growing inter-Korean exchanges at various levels. This chapter concluded that the ROK business actors' positive expectations for the future potential of inter-Korean trade offered a fundamental background for the growth of inter-Korean trade despite the low net profitability.

The next three chapters will tackle the three actual factors that were more likely to support the ROK businessmen's behavior, with more direct causality, in terms of the inter-Korean trade under the security crisis. Chapter 5 will examine whether and to what extent the IKCF affected the inter-Korean trade. Chapter 6 will explore the likely influence of the North Korean move for economic reform on transforming the environment of inter-Korean trade. Chapter 7 will explore the South Korean business conditions that the SMEs have been facing as a key factor that promoted their trade with the DPRK. Chapter 5, 6, and 7 will be presented based on the results of survey conducted in the ROK to test the respective hypotheses.



## CHAPTER 5

### Inter-Korean Cooperation Fund

#### *5.1 Introduction*

This chapter will evaluate the effect of the ROK government's financial subsidization policy to promote inter-Korean trade and test whether and how much it affected the South Korean business community's decisions on inter-Korean trade. To do this, the chapter will investigate the establishment and use of the Inter-Korean Cooperation Fund (IKCF) and demonstrate the result of the survey conducted to show to what extent this Fund contributed to sustaining inter-Korean trade during the second nuclear crisis.

This chapter is organized into three parts. The first section will examine the existing debates on government intervention in private business by market actors and how they could be applied to the case of the ROK government in handling inter-Korean trade. The second section will explain how the IKCF, as one of the significant policy tools of the ROK government intervention to boost inter-Korean economic transactions, was formed and operated from its establishment in 1990. The section will also demonstrate a series of concerted efforts of the ROK government and the SMEs to secure easier access to the Fund in the context of the evolved government – business relationship in the ROK. The third section will intensively analyze the results of the survey to show that the role of the IKCF had only a limited effect in inducing South Korean SMEs to carry on inter-Korean trade during the nuclear crisis.

## ***5.2 Government intervention in inter-Korean trade***

The IKCF has long been tackled in the context of North Korea policy by the ROK government. Many South Korean analysts studied various aspects of the IKCF throughout the 1990s (Cho D.H. 1993, Choi S.Y.1999, Ahn D.S.1999). The main focus of these analyses was largely how either to raise (or increase) the Fund or to allocate it with greater efficiency in connection with how to deal with the DPRK. On the other hand, how to manage the Fund often became embroiled in foreign policy debates in terms of the ROK government's strategy toward the DPRK. Those who advocated the 'Sunshine Policy' argued the volume of the Fund should be maintained so that more national and subnational organizations could plan and undertake inter-Korean exchange events. But the critics including the opposition party made efforts to slash the volume assuming the events funded by the South Korean taxpayers have in reality provided support to the Kim Jong Il regime (*Hankyoreh* 23<sup>th</sup> November 2005).

However, such policy reports drawn up in a highly practical manner and the relevant debates obscured the substantial points that needed to be addressed in exploring whether the government intervention influenced and changed the non-governmental actors' behavior from the perspective of international relations as a discipline. Any attempt to identify the non-governmental actors' individual response to the government-led incentive program was largely underestimated.

To fill this gap in explaining the role the IKCF carried out not only in foreign but also domestic policy, this section will outline the contending perspectives on whether government intervention in a market-led economy can be justifiable and will explore the pros and cons surrounding the ROK government's support for private firms

conducting inter-Korean trade. On this basis, this section will shed more light on the IKCF's contribution to attracting private firms in engaging with the DPRK. This means this section will interpret the ROK government's financial subsidization policy for them by legislation as part of its broader domestic industrial policy rather than foreign policy agenda dealing with the DPRK. In exploring the government subsidization toward inter-Korean economic exchange within the context of domestic industrial policy, it is essential to examine South Korean political economy within the context of government-business relationship. Examining the trajectory of government-business relationship in the ROK economy will offer a useful insight to justify the government intervention in particular industry and in turn its trade with the DPRK.

### *Developmental state and economic crisis in the ROK*

There is a long list of works that have claimed an active contribution of government to national economic growth strategy. It was particularly true when observing the high economic growth strategy in Japan and the ROK after the end of the Second World War. Chalmers Johnson coined the term, 'developmental state' to explain the role of Japanese government in achieving its economic success (Johnson 1981). Since his formulation of state intervention in a capitalist economy, many scholars have attempted to explain the case of the ROK by applying the 'developmental state' model (Cumings 1984, Amsden 1989, Wade 1990). Analysts of East Asian economies identified common features with regard to the role of government in achieving unprecedentedly rapid growth in the South Korean economy in the 1960s and 1970s.

Johnson shed light on the positive intervention of government that brought about economic success in the ROK as well as Japan and Taiwan (Johnson 1985, 140). Wade stressed a close relationship between firms, banks and government in East Asian countries (Wade 1992). Prestowitz emphasized the significance of large-scale investment in strategic industries, in achieving high economic growth, mainly selected to realize government-led mercantilist aims (Prestowitz 1997). One of the common assumptions shown in that literature was that they viewed the state as a complementary entity with autonomy not incompatible with market-driven economy.

State autonomy as a fundamental premise to explain state-market relations in East Asia did not remain unchanged throughout the 1990s. As Skocpol (1985, 14) asserted, a crisis tended to transform state autonomy. This assumption became particularly evident in the ROK, unlike Japan and Taiwan, when it was hit by the financial crisis in 1997. As the Korean *chaebol* was blamed for causing economic meltdown by their uncontrolled and irresponsible expansion strategy, the crisis became a critical momentum to reveal undermined state autonomy in the Korean economy. Critics argued the state was captured, rather than properly disciplining it, by the growing power of *chaebol* within the mechanism of the so-called bureaucrats-*chaebol* alliance in the Korean economy (Yoon Y.K. 1999, 72-78). Observers also called Korean-style developmentalism<sup>37</sup> into question, pointing to unregulated liberalization and inappropriateness of the government-business relationship as a deeper root of the crisis (Woo-Cumings 1999,

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<sup>37</sup> For discussion, see Haggard and Moon (1983), Cumings (1984), Amsden (1989), Wade (1990), Woo (1991). Despite a variety of ways explaining the key path and pattern of economic growth in the ROK, they shared at least one point that placed the main emphasis on the government strategy to drive the achievement.

Heo U. and Kim S.W. 2000). As Krugman put it, the moral hazard of financial intermediaries, as a consequence of an inappropriate government–business relationship could be one of the key factors that caused the crisis in East Asia including the ROK (Krugman 1998). The government offered banks an implicit guarantee against a likely failure and the banks abandoned their responsibility to develop their capacity for risk management in an increasingly volatile global market according to this theory. The search for the political origin of the crisis from the internal contradiction in the ROK culminated when cronyism emerged at the heart of the debates. Those who advocated the cronyism-based explanation argued that the longstanding practice to exchange favors for bribes between government and business bred the economic vulnerability that resulted in sensitivity to external shocks (Kang 2002).

On the other hand, counter-arguments were made to demonstrate that overemphasizing government-business collusion misrepresented the nature of the financial crisis in East Asia as a whole. Haggard (2002, 38-45), for example, dismissed the downfall of East Asian developmentalism as a primary cause of the crisis. What was central in his argument was that corruption was so uneven between the individual crisis countries in East Asia that it could not be accepted as a consistent factor that triggered the crisis.

Nonetheless, it should be noted that the dysfunction of the government – business relationship before the outbreak of the crisis resulted in drawing less attention to the constructive role of government in reshaping the Korean economic development strategy after the crisis. One exception from this propensity was government subsidization of a particular industry. This direct subsidization of a particular industry,

not a particular business conglomerate, remained less criticized even after the crisis. As Haggard put it (Haggard 2000, 30), there was little ground for arguing that the crisis in the ROK resulted from governmental industrial policy. Rather, efforts were made to reaffirm a developmentalist strategy denying the so-called IMF prescriptions requiring unconditional disengagement of government from business (Chang H.J.2002, 2003). On this basis, the governmental subsidization policy targeting particular areas of domestic industry could offer an explanatory tool to understand the government funding scheme for inter-Korean trade not only before but after the financial crisis. This was particularly the case as the main beneficiaries of the trade-funding for inter-Korean business were SMEs, which are more vulnerable than the *chaebol* that constituted the core of government-business collusion in the ROK.

### *Pros and cons*

Government intervention in inter-Korean trade, likewise, generated an intensive debate surrounding its appropriateness. The main point was whether it could be justifiable for government to support private firms (Yoo S.H. 2000, 76-82). Scholars and policymakers who advocated more active engagement by government insisted that it would ultimately result in lowering political and military costs in dealing with the DPRK in the future. They believed that government intervention could bring a more cost-effective option facilitating a likely inter-Korean reconciliation by improving the predictability of how and in what direction the future DPRK regime would proceed. This belief was built upon their expectation that inter-Korean economic exchanges

would ultimately contribute to creating a market-oriented economy in the DPRK. They viewed the efficacy of such an outcome – recovery of national homogeneity and improvement of military security – as invaluable and indispensable in North Korean economic transformation (Ko I. D. 1999, 9).

Even those who anticipated an imminent collapse of the DRRK regime emphasized the need to mobilize all possible inducements toward the DPRK. Foster-Carter (1998, 37), for example, insisted on ending all bans on civilian contact with the North since they were simply unenforceable and undemocratic. The advocates of government intervention in the inter-Korean economic engagement further insisted that the ROK government should be ready to consider the likely financial risk the ROK trade firms might face. They suggested two policy ideas which later led to stipulations in the ROK's relevant law. They were reimbursement of likely financial loss and debt surety by the government (Dong Y.S. 1999, 26).

Opponents of government intervention, on the other hand, argued that the pursuit of inter-Korean trade as a channel to acquire private gain ought to be conducted under the principle of self-responsibility. They refused to jeopardize taxpayers' money by investing it in a politically unstable country. They required a 'constructive disengagement' between government and business (Noland 2000, 352). The opponents argued that there would be no motivation for the DPRK to learn how market principles work and how to trade with South Korean companies as long as the ROK government subsidized South Korean firms (Tait 2003, 326). They found the key factor explaining the stagnant inter-Korean trade was not the lack of government intervention but the fragile infrastructure and low economic demand in the DPRK (Cho D.H. 1993, 23).

Those who are concerned about the danger of the DPRK military armament claimed that inter-Korean trade will end up reinforcing its military capability. They argued, in contrast to the hopes of the ROK government, that the DPRK would attempt to form a closer relationship with Washington and Tokyo through using enhanced economic potential stemming from benefits from preferential inter-Korean trade. They warned that Seoul could have been sidelined if this scenario had come true (KIET 1989).

### *Domestic industrial policy*

It was right in principle for the ROK business community to commercially engage with the DPRK without recourse to taxpayers' money. Self-responsibility in inter-Korean trade however should not be understood as denying the government's role as a unitary actor empowered to establish and enforce the relevant guidelines. Setting up new guidelines was particularly essential for regulating or coordinating economic transactions between totally different economic systems. One of the most frequently cited criticism regarding the ROK government's intervention in inter-Korean trade was the argument that the South Korean companies granted the Northern counterparts excessively concessionary terms of trade through expecting the government's support in case of failure. The critics assumed that the ROK companies had a belief that the government would indemnify them for losses that might be caused from the inter-Korean business on any occasion (Tait 2003, 326). They however ignored the fact that the policy tool that already allowed the ROK government to make up private firms' loss

had not been implemented for 14 years since 1990 when the conservative Roh Tae Woo administration enacted the 'South-North Cooperation Fund Act'. Although the Roh Tae Woo administration arranged the provision in question in which the legal ground for such loss-subsidization was stipulated, it was not implemented until May 2004 (*Dong-A Ilbo* 14<sup>th</sup> May 2004). This meant that the Kim Dae Jung administration (1998-2002), unlike the critics' untested assumption, did not permit the ROK companies to use taxpayers' money to make up their own losses that came from their misjudgement in inter-Korean trade.

The criticism that claimed the ROK firms' irresponsibility could also not be accepted. The South Korean SMEs already faced a plight where they had to worry over their own danger of bankruptcy in the early years of the Kim Dae Jung administration. It was a result of the Korean financial crisis in which the banks already shrank credit flows in accordance with the conditions imposed by the IMF on the ROK economy (Sachs 1997, Wade and Veneroso 1998). This changed business environment pressed ROK small and medium sized companies to prioritize profitability above everything else, whether long-term or short-term, as the primary and supreme factor in every level of decision-making simply for their survival. They had no resources left to sustain unaffordable inter-Korean business simply to take the credit for something that seemed to be 'patriotic' (Lee J.S. 1998, 17).

Government intervention could also be justified when considering the discrepancy between the South and the North in terms of a channel of mutual economic interactions. The DPRK established quasi-government organizations to cope with the need to develop foreign economic relations. Government agents such as the Koryo National Industry

Development Association (KNIDA), Chosun Kwangmyongsong Economy Association (CKEC), and Chosun Asia-Pacific Peace Committee (CAPPC) took the leading role in implementing the DPRK's trade policy. The roles of these *de facto* state agents were not confined to setting up overall guidelines for its dealings with trade partners in the South. These were in effect the only channels which the other party wanting to trade with the DPRK entities could and should contact. Although individual trade companies owned respectively by the Korean Workers' Party, the Cabinet and the Korean People's Army acted as contractual title-holders with Southern counterparts, all the companies were under the control of these quasi-government organizations (Lim K.T. 1998, 45). On the ROK side, on the contrary, the role of the similar quasi-governmental organizations such as the Korea International Trade Association (KITA), Korea Trade and Investment Conference (KOTIC) and Small Business Corporation (SBC) was no more than information sharing and technical support for on-site production on the DPRK territory. Government intervention in inter-Korean trade in this sense should be understood as an unavoidable response to the need to monitor such asymmetric interactions between the quasi-governmental North Korean agencies and the private companies in the South and on this basis to prepare to resolve likely disputes, if necessary.

### ***5.3 Inter-Korean Cooperation Fund***

This section will explore the establishment and operation of the IKCF as a primary policy tool for government intervention in inter-Korean trade since the 1990s. The section will particularly focus on how the Fund was allocated and disbursed to the South Korean SMEs involved in inter-Korean trade. To highlight the fact that the IKCF was

connected to universal domestic industrial policy conducted by the government, three points will be discussed. They were the changed government-business relationship, the changed role of the state in the ROK, and diversified agendas and channels in inter-Korean relations.

### *Establishment of the Fund*

The ROK government has established and run a number of funding schemes to fulfil specific demands needed to achieve its policy goals. The first fund of this kind was formed in 1961. As of April 2009, the ROK government had sixty two funds to meet the individual ministries' industrial demands (MOSF 2010). Promoting information technology industry and supporting agricultural industry could be examples of such policy goals by the individual ministry. The Ministry of Information and Communication (MIC) and the Ministry of Agriculture, Forestry and Fisheries (MOAF), in this context, could have greater discretion in deciding where and when these funds should be disbursed. One of the merits for an individual ministry in this funding scheme was that it was relatively less regulated and controlled by the legislative body. A discretionary judgement was more likely to be accepted in managing this fund than the annual national budget that needed to thoroughly be ratified and audited by the Korean Assembly (Yoo S.H. 2000).

Raising the IKCF in 1991 was likewise a part of these efforts to cope with the urgent need to promote inter-Korean exchange and cooperation. The ROK government established the legal basis of this fund in 1990 when it enacted the 'South-North

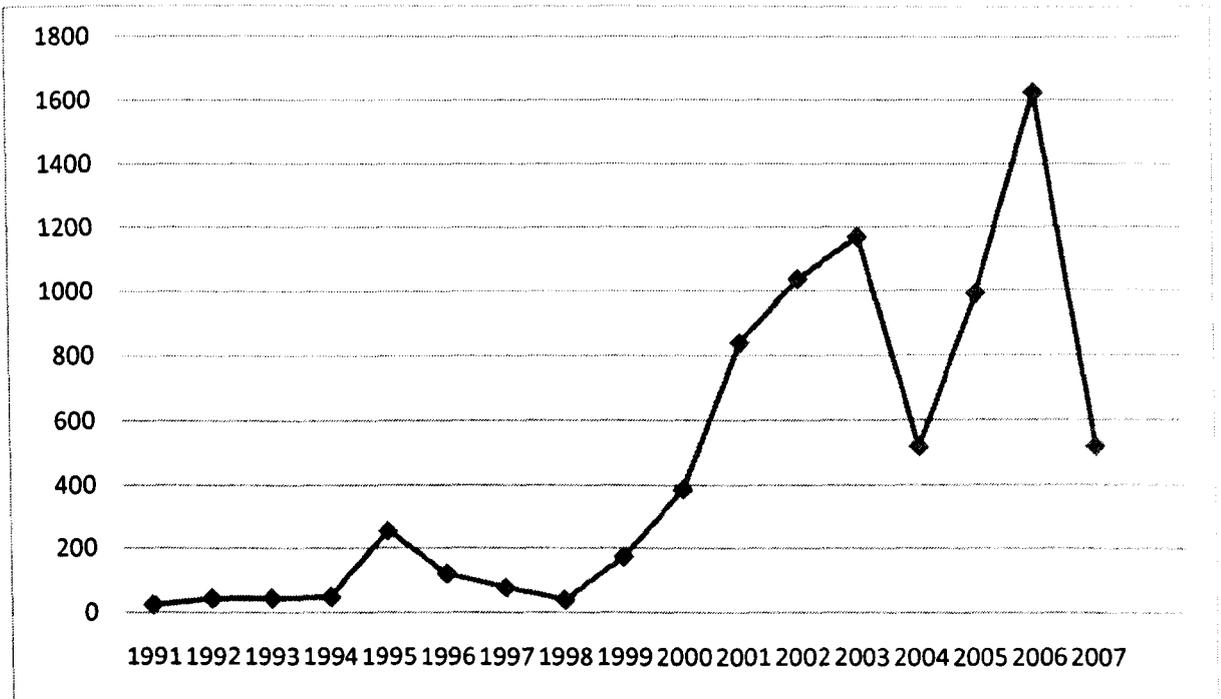
Exchange and Cooperation Law' and the 'South-North Cooperation Fund Act' under the Roh Tae Woo administration. The initial volume of the Fund was 25 billion KRW (some 28 million USD) in the first year, 1991. Among the total volume of the Fund, although there was a certain degree of fluctuation, the government's direct contribution always exceeded 90% of the total in subsequent years. This meant that most of the Fund came from the ROK taxpayers (Choi S.Y.1999, Nam S.W. 2004)

As the Fund by nature aimed to promote inter-Korean exchange and cooperative projects, the contribution of the Fund was inevitably affected by the political climate in overall inter-Korean relations in the particular period. For example, the amount of the Fund raised in 2001 and 2002 showed a sharp increase when inter-Korean relations had been undergoing a dramatic thaw after the summit between Kim Dae Jung and Kim Jong Il. In contrast, it tumbled when political tension arose again due to the confrontation between the two Koreas as a result of the eruption of the 2002 nuclear crisis in the Korean Peninsula (Nam S.W. 2003, 40-41). In particular, the then opposition party led the campaign to slash the Fund in the Korean Assembly, especially in 2003-2004 in an attempt to smear the inter-Korean cooperative projects led by Kim Dae Jung. Figure 5.1 shows the fluctuation of the annual amount of money raised after 2000 in relation to the change of political environment.

The political turbulence in the Korean Peninsula not only affected the aggregate volume of the Fund but also constrained the occasions and the kind of projects for which the Fund could be disbursed.

Figure 5.1 The amount of annual fund-raising of the IKCF

(Unit : billion KRW)



Source : MOU (2008)

Despite the fluctuation in the annual national budget allocated for the Fund depending on turbulence of inter-Korean relations, what was striking was the volume of the accumulated Fund between 2002 and 2006 which showed remarkable growth in comparison with the previous five years (1997-2001). This suggests that the impact of the second nuclear crisis initially erupted in 2002 failed to reach a substantial level when it came to the size of the Fund.

### *Allocation of the Fund*

The expenditure of the Fund was strictly limited to several categories of stipulated use in the relevant law. They were aid, loans (for large-scale projects in North Korea), lending (for South Korean private firms), and compensation for business loss. The first category, aid, was established with the purpose of putting forward a range of events and activities to facilitate inter-Korean reconciliation. It included the support of family reunions, sports, and cultural events between the South and the North, let alone humanitarian aid projects, all of which were likely to contribute to restoring national homogeneity that had been seriously undermined since the division of the Korean Peninsula. The expenditure based on the aid category accounted for the vast majority of Fund. The second category, loans, was targeted to launch larger-scale national projects such as the establishment of the KEDO, large-scale food aid toward the DPRK population. The cost involved in supplying materials in implementing railway reconnection projects agreed in the inter-Korean summit was also disbursed within this category. The third category, lending, aimed to support South Korean businesses that planned or undertook business with the DPRK entities. The loss compensation provision was implemented relatively late in comparison with the others. The ROK government did not use the Fund until 2004 for the purpose of compensating South companies struggling from financial losses stemming from inter-Korean business. The ROK government laid down detailed guidance on how to operate the compensation scheme in

2004 after the two Koreas reached the investment guarantee agreement to ensure the safety of South Korean properties and assets in North Korea.<sup>38</sup>

As shown in this categorization, the Fund permitted expenditure for the purpose of lending money for private firms involved in the inter-Korean business. However, the ROK government did not authorize any expenditure to directly subsidize private firms by the Fund considering the fact that the source of the Fund came from taxpayers. Loans were only given for projects for humanitarian food aid and the LWR project agreed in the 1994 Agreed Framework (MOU 2000, 49). The support for private firms in inter-Korean trade was the least acknowledged part of the Fund. As of 1999, for example, among 18 cases approved, 17 cases were implemented in order to offer the DPRK humanitarian aid and to organize joint events conducive to reconciliation of the two Koreas. The ROK private firms were by no means considered when allocating the Fund except in one case (Yoo S.H. 2000).

The strict regulation and monitoring of Fund expenditure however did not necessarily imply that forming and consuming the Fund should be directed by the inter-Korean political situation. The volume of the Fund saw a dramatic increase in 2001, which nearly doubled the previous year's volume, for example, despite the stagnation in the inter-Korean dialogue at the governmental level. This showed that the inter-Korean exchanges and cooperation projects at the civil level grew despite a less reconciliatory

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<sup>38</sup> The Agreement was one of the four major pacts arranged in accordance with the political agreement between Kim Dae Jung and Kim Jong Il in the 2000 summit confirming the 'balanced' development of Korean national economy. Four major pacts included, apart from the investment safety agreement, the double taxation avoidance agreement, the dispute settlement agreement, and the clearance of accounting transaction agreement. See MOU (2004).

political environment at the state level and it affected the size of the Fund (Nam S.W. 2003, 43).

Whereas the inter-Korean exchange programs by civil organizations grew, the ROK firms planning and carrying out inter-Korean business were still omitted from the beneficiaries of the Fund. The share of the Fund allocated to the business sector on a private loan basis did not exceed 10%. The biggest obstacle to block the allocation of the Fund for an inter-Korean business purpose was the political disagreement over the subsidization towards private businesses using taxpayers' money.

#### *Domestic politics of inter-Korean economic exchanges*

The GNP, the opposition party, has been far less inclined toward engaging North Korea economically compared to the Kim Dae Jung and Roh Moo Hyun administration. The conservative party believed that further inter-Korean economic exchanges, whether it was commercial or non-commercial, should hinge on North Korea's commitment to denuclearization. The GNP, in the same vein, insisted the Fund raised mostly by taxpayers' money should be strictly controlled not to be spent in a risk-taking manner.

The political controversy over the IKCF shows that the inter-Korean economic cooperation in nature concerned domestic politics as well as foreign policy means towards North Korea. Whereas the Kim and Roh governments tried to help ease restrictions in disbursing the Fund stressing political necessity or urgency, the GNP attempted to tighten up the rules on cash flow to the communist regime. The governments and ruling party maintained that the Fund should be immediately

responsive to the demand, even unexpected ones, coming from the change of inter-Korean relations. Their claim was built on the assumption that the Fund operation should be heavily controlled by the government's own discretion. On the contrary, the GNP insisted that the management of the IKCF lacked transparency and the government should seek parliamentary endorsement before pushing ahead with allotting government funds to private businesses.

As an example, a group of GNP lawmakers brought in a lawsuit against the government's plan to provide the Mount Kumkang tourism project with 9 billion KRW support from the IKCF (*Kookmin Ilbo* 5<sup>th</sup> July 2001). Under the Kim Dae Jung and Roh Moo Hyun administration, the opposition party continuously sought to revise the relevant law in an attempt to reduce the government discretion in the Fund management.

Right after the Roh Moo Hyun – Kim Jong Il summit in 2007, the then GNP chairman, Kang Jae Seop reminded taxpayers that the increased economic investment in North Korea in the wake of the summit is going to cause serious deficit in national budget.

Some estimations show that the South could end up supplying the North with up to 30 trillion won (USD 32 billion) due to the latest inter-Korean summit. This would be a major burden on the people (*Dong-A Ilbo* 12<sup>th</sup> October 2010).

The dramatic change of the policy line with regard to the Fund management after the conservative GNP candidate Lee Myung-bak won the presidential election in 2007 was another example that showed the political nature of the IKCF. In 2008, after Lee took office, the Ministry of Unification disapproved one in three applicants for the Fund and it showed a sharp difference from the previous governments' policy in which more than 90% of the projects proposed were generously approved every year (*Munhwa Ilbo* 16<sup>th</sup> May 2008). As a result, the overwhelming majority of the Fund remained unused since the inauguration of the Lee Myung-bak administration. Moreover, the Ministry of Unification of the Lee administration rigorously reviewed the Fund and condemned the previous administration's policy by describing it had lacked transparency and effectiveness (*Dong-A Ilbo* 16<sup>th</sup> December 2008).

Even though there were elements of government intervention in the ROK's industrial development, the highly debatable nature of the IKCF and the political reality derived from it made it more difficult to support private business by using the Fund. However, South Korean SMEs continued to make lobbying efforts to lower the barrier to access the Fund. They insisted that the exclusion of small business from the beneficiary group of the Fund was unfair treatment, given the long practice of ROK industrial policy that has exploited the discretionary fund held by individual ministries.

### *Deregulation for small business*

Although there were a series of efforts to offer private firms a more easily-accessible route to the Fund, in the absence of a consensus in the political controversy,

the consequence of the efforts was not as satisfactory as the businessmen hoped. One South Korean entrepreneur who claimed he had lost 1.7 billion KRW (some 1.9 million USD) through inter-Korean business since 1990 stated that ;

The ROK government had offered preferential loans to those who were suffering from the credit crunch in most of the subfields in the domestic industry. The only exception however was inter-Korean business. Presumably the reason why the government turned us away might be the fact that we took part in business with a communist country. The IKCF of 300 billion KRW (some 300 million USD) is of no use for small business. Even though the government recently announced a measure to reinvigorate inter-Korean economic cooperation, no financial support was given to small business nearly at risk after the IMF crisis. Who on earth will continue this task once SMEs accounting for 95% of the inter-Korean business collapse?  
(Kim Y.I. 1998, 25)

As shown in his statement, the SMEs in the ROK had a feeling of deprivation in comparison with other companies involved in international trade with a third country. Moreover, the necessity of financial support for the SMEs was acute given the fragile investment climate and weak institutional foundation in the North Korean economy (Lim B.C. 2002, 24). It should also be noted that voices demanding governmental support for inter-Korean business by SMEs had already been raised since the early 1990s (Lee K.H. 1999, 17). Another ground for the need to support the SMEs came

from the vulnerable standing they faced after the economic crisis in 1997. The economic crisis was initially triggered by a currency crisis in the ROK and moved to a series of banking crises and in turn a credit crisis, which resulted in high credit crunch for domestic borrowers. In this chain of crisis, one of the weakest participants was small business that had maintained highly leveraged financial structures.

However, inter-Korean business in the early years of the 1990s was not considered even in line with government's trade expansion policy that encouraged commercial banks to provide trade-related SMEs with preferential finance program. The common dissatisfaction of South Korean SMEs was that commercial loans from the IKCF required (a) too short repayment timescale (b) too much collateral (c) too complicated and time-consuming procedures (*Kyunghyang Shinmun* 14<sup>th</sup> February 2000). The ROK business believed that these demerits prevented them from gaining access to the Fund.

To unblock this bottleneck, from 1999 to 2007, the ROK government made a series of announcements about promoting more active engagement of SMEs in inter-Korean business. It ranged from the grant of a premium interest rate for the SMEs' loans to the measures to accept borrowers' investment assets in the DPRK as collateral security for loan arrangements.

Table 5.1 Key features of deregulation in the IKCF

Date	Actions taken
October 1999	Private loans from the Fund permitted
December 2001	Interest rate for loans decreased, credit facilities increased
February 2003	Premium rate for SMEs introduced, loan procedures simplified
January 2004	Assets in North Korea accepted as collateral for bank loans
May 2004	Loss compensation scheme commenced
February 2007	Scope of loss compensation expanded

But, in essence, it was concerted efforts between government and small business that substantially lower the barrier which had been blocking development of inter-Korean business. To understand the fundamental backdrop of this coordinated policy, the change in both the international and domestic landscape needed to be investigated. All these showed a changed relationship between government and non-governmental elites under the changed international politics that could be explained by way of the complex interdependence model. In an era of complex interdependence, non-state actors (e.g. business, civic organizations), to a greater or lesser extent, played the role of transmission belt that caused a bigger sensitivity to the government's foreign policy and domestic mechanism to efficiently implement it (Keohane and Nye 1989, 26). Informal communications between non-state actors, without recourse to diplomatic channels, provided states with opportunities either to establish a new rule or to review and transform existing ones. Increased transnational interactions further hastened the emergence of different patterns of regulation. In this process, the government–business relationship underwent more consensual engagement beyond the conventionally bipolarized description on whether the state had autonomy or not from the market.

Closer observation of the government – business relationship in the domestic politics of the ROK will offer clearer guidance to understand the political economy of inter-Korean trade. It also gives an answer to the question as to how the continued lobbying and petitioning by South Korean SMEs lowered the barriers that had constrained their access to the Fund over more than ten years. Three points should be emphasized to explore such conditions. Firstly, it is worth noting that the standing of the

South Korean SMEs underwent a certain degree of change in comparison with *chaebol* when it came to inter-Korean trade. South Korean industrial policy had largely been portrayed as a growth-oriented, unbalanced, *chaebol*-based strategy. SMEs were regarded as either a secondary player or a victim of economic concentration strategy jointly led by the ROK government and the *chaebol* groups. It should however be noted that such an analysis simply showed a part of what had been done in the ROK industry in the 1980s and 1990s. Since the downfall of the Park Chung Hee regime, the next president, former general of the Korean Army, Chun Doo Hwan introduced a stabilization policy to place more control over the *chaebol*. The monopoly regulation and credit restriction program by the Chun Doo Hwan government offered a greater space for SMEs to access previously scarce opportunities for their business expansion (Moon C.I. 1994). While the symbiotic government-business relationship began to be shaken, a set of new financial support programs was introduced to correct the heavily biased credit rationing that had favored the selected *chaebol* groups (Park H.J. 2001). Particularly after the economic crisis in the late 1990s, the South Korean *chaebol* strategy typified by unregulated expansion attempts became more questionable (Woo-Cumings 1999). Being forced to drastically lower their debt-equity ratio by the government, under pressure of the IMF conditionality, many South Korean *chaebol* sought to fundamentally reconstruct their investment system into an inward-oriented, risk-averting, and more conservative pattern (Crotty and Lee 2002). *Chaebol* were scarcely willing to participate in large-scale investment in the DPRK territory in pursuit of their stability-oriented strategy. The only way to push forward inter-Korean economic cooperation reemphasized in the 2000 Inter-Korean Joint Declaration was to induce

SMEs to respond to the government agenda. Concerted policy consultation with SMEs was indispensable if the ROK government was to continue to maintain the momentum to push inter-Korean economic projects forward.

Secondly, the changed role of state in the modern political history of the ROK in terms of economic management should be investigated. Economic development in the 1960s and 1970s, mostly under Park Chung Hee's leadership, showed that the ROK could be classified as a 'strong' state with a powerful state apparatus. Along with 'iron-fist' style leadership by Park, coherent cultural and ethnic homogeneity made the ROK a 'strong' state.<sup>39</sup> The nature of a strong state under authoritarian leadership was maintained on the political front throughout the Chun Doo Hwan government that replaced Park after his assassination. But Chun's economic advisory group led by someone with an American Ph.D in economics introduced a liberalized approach, unlike the military-dominated political line-up, to domestic economic management (Haggard and Moon C.I. 1990, Moon C.I. 1994, 145-152)<sup>40</sup>. Indirect control and less arbitrary resource allocation were preferred in comparison to the coercion and one-way guidance employed by the Park Chung Hee leadership. Later in the 1990s, the IMF conditionality imposed on the ROK government in return for the bail-out package further shrank the government's role in economic management (Wade and Veneroso 1998). The South Korean state could no longer take the role of sole authoritative planner in economic management. Rather, it turned into an enforcer and facilitator, or a mediator at times,

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<sup>39</sup> According to Buzan, a lack of coherent cultural group, diversification in ethnicity, a presence of violent dissident group in connection with foreign agents constituted main elements of 'weak' state, which had mainly seen in the Third World immediately after decolonization (Buzan 1991, 96-100).

<sup>40</sup> Chun Doo Hwan appointed Kim Jae Ik, Stanford University PhD holder with a neoclassical background in economic policy, as his chief economic aide and gave him great discretion to pursue liberalization policy in terms of interest and exchange rate. See Kang K.S. et al.(2003).

which sought to make the business activities chosen by private sectors more vibrant as well as viable. A range of consultative mechanisms between the state and non-state interest groups assisted such facilitation and mediation. But the fundamental driver to bring about the evolved SME policy by the ROK government was not the organized power of the SMEs but the refashioning of the state's nature.

Thirdly, the emergence of various issue areas, as significant as conventional military issues in inter-Korean relations offered favorable conditions to make government-business consultation workable. The enactment of the 'South-North Exchange and Cooperation Law' by the ROK government in 1990 signalled that the exchange channels and agenda in inter-Korean engagement would be diversified. The increasing number of multiple issues in inter-Korean relations involved an increasing number of South Korean domestic actors and in turn caused an overlap of South-specific domestic issues and inter-Korean agendas. The inter-Korean agenda, in other words, required a realignment of domestic guidelines in terms of eligibility and conditions to give permission for South Korean actors to engage with their North Korean counterparts. As Keohane and Nye demonstrated, the overlap of domestic and foreign policy agendas tended to involve domestic legislation or regulation (Keohane and Nye 1989, 26-27). The issue diversification in inter-Korean agenda became one of the key elements that promoted government – business consultation in the ROK and that brought about the subsequent achievement of a range of deregulation.

Nevertheless, a series of deregulation measures designed and implemented under the changed relationship between state and non-state actors and *chaebol* and SMEs failed to completely satisfy the inter-Korean traders on the South side. The South

Korean SMEs still claimed the governmental decision-making process for loan arrangements was so dilatory that the intended money could hardly be delivered to the firms in need at the proper time (*Munhwa Ilbo* 28<sup>th</sup> December 1999). More substantial changes to galvanize the Fund were suggested such as no-collateral credit loan permission. Those who demanded bolder measures insisted that the government should guarantee a superior footing of the South Korean players who were struggling to compete with third country firms targeting the virgin North Korean market (Yoo S.H. 2000, 31-40). The opposition party in contrast urged tighter control over the Fund by curbing the arbitrary use by what they called 'pro-North Korean' government (National Assembly Secretariat 1998, 191-192).

It was the 'Investment Guarantee Agreement between the ROK and the DPRK', signed in December 2000 and taking effect in August 2003, that decisively eliminated the potential risk of the commercial loan program from the Fund. Until then, in the absence of such a guarantee system, the overwhelming majority of investment assets created by South Korean firms in North Korea were regarded as a potential loss on their balance sheet. They were of no use in applying for loans from the Fund as they could not be accepted as reliable collateral. However, following the ratification of the Investment Guarantee Agreement in both South and North Korea, the two parties had an obligation to permit and protect each other's investment in their own economic area. Most Favored Nation (MFN) treatment was also granted to the assets invested in the counterpart territory (MOU 2004). By insuring against the loss of the assets in the DPRK, the Investment Guarantee Agreement enabled the South government to approve loan applications based on assets in the North.

The ROK government, as a result, announced a set of preferential measures to boost SMEs' participation in inter-Korean business. From January 2004, the South Korean SMEs were permitted to claim loans based on their buildings, production facilities, parts, and materials they were planning to transfer to the DPRK. The SMEs specialized in POC trade were especially qualified to benefit from the Fund retrospectively (*Hankyoreh* 30<sup>th</sup> January 2004). From February 2005, the SMEs' production facilities and assets in the KIC began to be accepted as collateral for additional loans from the Fund. The ROK government's decision to indemnify inter-Korean traders for likely losses not caused by their own fault eliminated another obstacle. Although suggestions had been made since the 1990s arguing the potential risk from the inter-Korean trade should be taken, or at least shared, by the government (Lee K.H. 1999, 17), it was still a controversial and explosive issue in that the major financial source of the compensation for private companies should come from taxpayers' money. The mainstream public opinion in the ROK was highly polarized surrounding the inter-Korean economic cooperation projects that provided the North regime with considerable amounts of hard currency. Considering this domestic public opinion, the ROK government did not take any action to indemnify any losses from inter-Korean business until 2004.<sup>41</sup> In May 2004, the ROK government announced that a new loss compensation scheme under the Fund would take effect. The scheme was designed to safeguard the SMEs' potentially risky investment in the DPRK. It aimed to cover

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<sup>41</sup> The only exception was the case where the Fund reimbursed 1.2 billion KRW (some 1.3 million USD) in 1991 for Chonji Trading Company in the South that undertook barter trade with its North Korean counterpart. In this deal, a North Korean trading company failed to send cement and coal in return for the rice delivered from the South. It was recorded as the first and the only case that the ROK government agreed to cover the loss with regard to the expenditure of the Fund. The government no longer underwrote any claim for the loss coverage since then.

unexpected financial loss not attributable to South Korean firms such as a North Korean refusal of currency transactions, delay in payment or delivery, and bankruptcy of the North Korean counterpart (*Dong-A Ilbo* 14<sup>th</sup> May 2004). Although the scheme had a maximum limit for compensation (50% of the amount of loss) and it charged an application fee with the amount depending on the applicant's credit rating, it was accepted as a significant progress in relieving risk in inter-Korean trade (Yoo Y.K. 2004). Additional actions were taken in February 2007 to expand the scope of potential beneficiaries from the Fund. The ROK government made the decision to cover losses not only from North Korean breach of contract but also from the South government's policy change which was beyond the control of the SMEs (*Naeil Shinmun* 26<sup>th</sup> January 2007). As a result, the continued endeavor by the ROK government to ease the conditions for loan and expand the beneficiary group of the Fund made a favorable environment to get more SMEs involved in inter-Korean trade and investment projects during the unfavorable political climate.

#### ***5.4 Results of survey***

The focus of this survey, as a key methodology to test the three hypotheses outlined in chapter 1, was to explain what motivated the South Korean SMEs to maintain or rather increase their trade volume with North Korea during the second nuclear crisis. Among the three hypotheses, government subsidy, more specifically, the injection of the IKCF and a series of measures to enhance the accessibility to the Fund, turned out to bring limited effect in sustaining inter-Korean business during the crisis. For the question asking for the main factor, only 11% of the respondents acknowledged

that the government intervention including the increased allocation of the Fund into their business had made a crucial contribution to the reinvigoration of inter-Korean trade during the crisis. For the question asking whether the reinvigoration package by the government influenced their decision-making with regard to the inter-Korean trade, 31% of the respondents said 'yes' whereas 35% said 'no' and 35% responded 'not sure'. This implied that the government's direct intervention had had a limited effect in promoting inter-Korean trade during the crisis.

On the other hand, more than half of the respondents (54%) acknowledged that the worsened business environment of the domestic manufacturing industry influenced their decision. The majority of South Korean entrepreneurs (53%) chose the worsened domestic business environment as the first and foremost cause not to cut down their business volume connected with the North Korea entities.

The ROK government have continued to make an attempt to increase accessibility for the domestic business actors to the IKCF since the Kim Young Sam administration. The Fund was a significant policy tool to technically increase or decrease the width and depth of the government intervention in inter-Korean trade subject to changes in the political environment. Nevertheless, the survey results suggested that the South Korean SMEs did not acknowledge the contribution of the IKCF as a top element that enabled them to keep engaging with the DPRK during the nuclear crisis. For example, Bae Ki Young, a veteran inter-Korean trader and advisor of Now Corporation, importer of North Korean minerals, said in an interview that the great majority of inter-Korean traders including his company did not receive even a single penny from the IKCF in planning and carrying out the agreed transactions with the DPRK counterpart. The

alleged massive amount of money raised for the Fund, according to his experiences, existed beyond most inter-Korean traders' reach due mainly to the long list of conditions required. He also said that the majority of inter-Korean traders tended to change their business field quite often depending on the industrial demands they discovered in the South Korean market.

It showed that the South Korean businessmen responded even more sensitively to the push factor (deteriorating domestic business conditions) rather than the pull factor (government direct subsidization). The result of the survey illustrated that the government's role, as a director and powerful manager that had been supported by the advocates of the developmental state, considerably shrank under the complex interdependence in inter-Korean relations. Instead, the autonomous judgement by non-state actors purely based on commercial sustainability took priority in every decision making process in inter-Korean business.

Apart from the three hypotheses, this survey also investigated a part of the likely main elements that promoted the South Korean SMEs' continued engagement with the DPRK despite the nuclear confrontation. As outlined in chapter 1, a couple of intuitive explanations have been attempted such as patriotic entrepreneurship and media attention as a reward for their business with communist regime that has been sharing national homogeneity with them. However, the data collected from the survey and interview conducted in the ROK dismissed the full credibility of those intuitive explanations. The majority (50%) of the respondents in the survey denied there was any consideration of non-economic causes such as peaceful coexistence and reconciliation of the two Koreas as a driving force to push inter-Korean trade forward despite the unfavourable business

climate. Only 35% answered that they took them into account apart from the commercial interest stemming from inter-Korean trade. It should also be noted that even this 35% did not mean political causes or the possibility of public fame were not a 'primary' driving force to take things forward. It was at best confined to the secondary or less important factor that motivated their decisions.

## ***5.5 Conclusion***

This chapter demonstrated that the IKCF was an integral part of the ROK government policy to locate inter-Korean economic interactions on a commercial basis by separating them from the political context. The Fund also offered an efficient policy tool to invigorate inter-Korean economic cooperation in the civil and private sectors. The evaluation of how the IKCF was formed and managed provided sufficient justification for the government intervention in inter-Korean commercial transactions in the private sector. The IKCF was far from the conventional pattern of the rent-seeking behavior by central government such as licensing and lax tax. Under the Kim Dae Jung and the Roh Moo Hyun administrations, the avenue through which the domestic actors were allowed to directly engage with the DPRK was broadened and diversified. Rather, international security variables uncontrolled by the government's domestic economic policy were likely to preclude a freer flow of resources between the two Koreas. The IKCF was devised and operated to install a buffer absorbing the unexpected risk likely to be caused by escalation of political or military tension. Whereas the players ought to cope as immediately as possible with the security issue areas, economic projects required longer time-consuming preliminary work such as the construction of infrastructure and large-scale manufacturing facilities.<sup>42</sup> The IKCF offered a bridge to overcome this time-lag which could more often happen because of the destabilized relationship between the DPRK and the external powers.

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<sup>42</sup> The abortive LWR project provided a good example of the failure of the agreed large-scale economic projects as a result of the re-emergence of military confrontation. The KEDO, the international organization that led the LWR project, was dismantled in 2006 in the wake of the continued confrontation since the outbreak of the 2002 nuclear crisis.

However, this chapter concluded that the government subsidization to reinvigorate inter-Korean trade through the IKCF brought about only limited effect. It was true that the ROK government intervention relieved political risks surrounding inter-Korean trade environment by offering the preferential loan program and loss compensation scheme. Nevertheless, the ROK government intervention typified by the IKCF did not constitute the first and foremost causal variable that shaped the change of the SMEs' behavioral pattern in economic engagement with the DPRK. Rather, the results of the survey suggested that the South Korean SMEs were more motivated by the worsening domestic business conditions stemming from rising production costs in continuing the inter-Korean trade but less motivated by the government's measures to take the risk from the inter-Korean business on their behalf. Such a response from the ROK businessmen suggested that the IKCF was handled within the perspective of foreign policy and without paying attention to industrial needs of the main actors involved – South Korean SMEs. Being dominated by the foreign policy concern aiming at creating a reconciliatory mood between the two hostile nations, a greater amount of money in the Fund was spent for one-off humanitarian events to meet the purpose. The Fund could have made a greater contribution to building a more stable foundation to improve a long-term relationship between the two Koreas, if it had been spent to meet the domestic industrial needs of the SMEs.

At the same time, it became impossible to capture how business actors coped with the nuclear crisis without shedding more light on the deteriorating business conditions after the IMF crisis in the domestic context in the ROK. This key finding in this chapter will be further amplified in chapter 7.

## CHAPTER 6

### Economic Reform in the DPRK after 2002

#### *6.1 Introduction*

This chapter will argue that a set of changes in the economic environment in the DPRK since the announcement of the reform package in 2002 have had little impact on the perception of the business community in the ROK in terms of inter-Korean trade. Although the North Korean move for the economic opening since the 1980s maintained a consistent direction at least until 2006, the chapter will demonstrate that it failed to reconfigure the foreign economic relations of the DPRK.

In dealing with the causal mechanism between domestic economic changes in North Korea and inter-Korean economic relations, the primary concern was whether and how much the South's trading with the North affected the pace and direction of the internal change in the North (Lee Y.H. 2004, Bughart 2009). However, this chapter, in contrast to such approaches, will follow the opposite direction. To do this, this chapter will ultimately investigate whether and to what extent the move of economic changes in the North affected the scale and pace of inter-Korean economic engagement. This investigation will assess the appropriateness of the second hypothesis (reform signals from the North) explaining the increased inter-Korean trade during the second nuclear crisis.

This chapter is organized into four sections. The first section will review the theoretical and practical debate on how to evaluate the intention and direction of a series

of new initiatives announced in July 2002 to improve economic efficiency in the DPRK. The so-called 'measure for the improvement of economic management' announced in July 2002 covered various sub-areas of the North Korean economy. Although this whole chapter will be confined to tackling a specific part of the sweeping reform related to the DPRK's foreign economic relations, this particular section will address the overall picture of the reform to assess its motive and ramifications. The second section will trace back the historical ground of the reform which laid the foundation of the decentralization move, one of the key elements in the 2002 reform package. This section will shed light on the efforts of the DPRK in the 1980s and 1990s to escape from its ideologically based national economic order. The efforts included the designation of free trade zones and the partial permission for exchanges of materials between frontline factories outside the central allocation system. The third section will assess the impact of some aspects of the 2002 reform package likely to bring about a greater interdependence with the ROK, the second largest trade partner of the DPRK. The main features in the package related to how to improve the North's foreign economic relations were the measures such as decentralization, trade promotion, and the introduction of the profit motive in production management. The fourth section will provide survey results showing how big an impact the North Korean reform had on inter-Korean trade after 2002. This chapter will conclude that the reforms in the DPRK had also limited impact on changing the perception and behaviour of the business community in the ROK when it came to inter-Korean trade.

## ***6.2 Debate on the reform***

This section will explore the two contending arguments on how to evaluate the North Korean move of economic reform after 2002. Some viewed the reform experiments as aiming to introduce comprehensive market mechanisms in an attempt to reconstruct the ailing North Korean economy. Other scholars downplayed the likelihood of marketization in the socialist economy as long as the DPRK central government maintained strict ideological control in terms of the management of their socio-economic system. They rather argued the would-be reform measures were in fact a part of their endeavors to strengthen its regime control following a crisis caused by dysfunction within its public distribution system.

### *New pathway for market mechanism*

According to those who supported the argument for marketization reform of the North Korean economy, the experiments undertaken in the DPRK from 2002 had illustrated various features of market socialism that China and Vietnam had previously pursued (Guo and Stradiotto 2007). A series of measures typified by the price reforms at least strongly suggested the coexistence of a state-directed economy and a market economy (Frank 2005a). This 'hybrid system' (Frank 2005b) of post-reform North Korean economy provided grounds for accepting it as a 'starting point of market reform' while acknowledging the provisional and unstable characteristics of the North Korean reform in nature (Kim Y.C. 2002).

Kornai emphasized three factors in defining 'reform' in a socialist system. He argued there must be 'moderately radical alteration' in at least one out of the three defining elements of what he called 'reform' : (1) undivided power of the Marxist-Leninist Party (dominant influence of the official ideology), (2) dominant position of state and quasi-state ownership, (3) preponderance of bureaucratic coordination (Kornai 1992, 387-88). Lavigne, on the other hand, identified three key characteristics of economic reform in a socialist regime based largely on the observation of the experiences of Eastern European countries. Those were (a) loosening of party control (b) reduced state ownership monopoly (c) combined market and planning (Lavigne 1995, 29-43).

In light of these definitions, a series of North Korean policy packages since 2002 was sufficient to be called 'reform' allowing limited introduction of market mechanisms. The implementation of the package from 2002 ranged from permission for discretionary trade in a part of agricultural output to the guarantee of autonomous power of factory managers. The most salient change emerged from ownership relations, which was one of the most sensitive areas in a socialist economy. The DPRK authority expanded the maximum size of private plots allowed for individual households to possess from 100~165m<sup>2</sup> (30~50 *pyong*) to 1320 m<sup>2</sup> (400 *pyong*)<sup>43</sup> from July 2002. At the same time, the guideline determining the size of working sub-units within a collective farm was eased, which resulted in promoting competition between the sub-units. The post-reform working sub-unit could be composed of five to six people. In

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<sup>43</sup> This figure includes so-called 'patch plots' (*Toi-gibat*). The DPRK authority allowed its population to run 'patch plots' apart from officially recognized 'kitchen gardens' (*tut-bat*). These became a useful resource in which the farmers could produce grains such as corn and rice not only for their own need but for surplus trading in the marketplace. For details, see Lee K. and Chun H.T.(2001, 212-16).

forming the sub-unit, family members were also allowed to join, which meant, in effect, family farming was condoned. A pilot project to officially introduce a private family farming system was launched in January 2004 to promote inter-family group competition (Kim Y.Y. and Choi S.Y. 2005). Although the economy remained largely state-owned and controlled, all these measures put in place in 2002 were significant moves to authorize private ownership. The Economist Intelligence Unit (2004), for example, reported that *de facto* private enterprises were emerging to complement or supplant the failing formal economy in the DPRK.

In the process of forging a coexistence of state and private ownership, the dominant power of the Party in economic management was inevitably weakened. The role of the Party secretary in economic planning and oversight shrank while the factory managers became more powerful in exercising their right to make relevant decisions (Kim Y.Y. and Choi S.Y. 2005, 24). Being less guided by the Party platforms, central bureaucratic control subsequently lessened with giving frontline managers more autonomy (Chung S.J.2003).

### *Consolidation of planning*

Those who believed the North Korean way of reform would not aim to introduce market mechanisms argued that the measures put in place in 2002 were designed not for economic revitalization but for regime stability. Although they did not expect the North Korean economic change would become completely pseudo-reforms, they put a greater emphasis on the intentions behind the measures rather than their direct/indirect impact.

The experiments were downplayed as efforts to increase Pyongyang's organizational control over its ailing economy (Hong I.P. 2002, Lee J.C. 2002, Hale 2005). They argued that economic reform in the DPRK without substantive reduction of military confrontation would be unrealistic (Shin J.H. 2002). Structural weakness of the DPRK economy hampering the success of Chinese style reforms was also pointed out (Cho D.H. 2004). The reform experiments were accepted as problematic especially in the event that Pyongyang encountered any type of regime instability. It was asserted that Pyongyang would be likely to take unhesitating action once it saw any indication of a decline in its regime legitimacy as a result of excessive economic adjustment (Ha S.S. 2004). These arguments evoked sympathy as the DPRK turned more cautious in the economic adjustment process from about 2006. The market reform measures originally shown in the 2002 blueprint became less ambitious after four years' intensive experiments. According to North Korean defectors, the DPRK government began to prohibit women in the farmers market<sup>44</sup> from trading goods from about October 2007 (*Chosun Ilbo* 9<sup>th</sup> November 2007). The farmers market, as a place in which basic commodities could be traded by individuals, shrank as a result of a series of crackdowns by the DPRK authorities (Lankov 2008, Park H.J. 2008). Unlike China's reform in the 1980s, Pyongyang intended to retain ideological control over its population while pushing economic liberalization forward (Liu 2007, 17). It showed that Pyongyang accepted the spreading farmers market as a threat to its regime stability. Pyongyang

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<sup>44</sup> As the food shortage worsened in the late 1990s due to the collapse of the North Korean central rationing system, individual farmers began to sell food grown on their household plots. The common place in which these transactions were made was called a 'farmers market'. Subsequently some makeshift stalls and kiosks run by local people began to appear for the purpose of selling non-farming goods such as shoes, clothes, and cosmetics in the farmers market (Smith 2005b).

became so reluctant to implement follow-up measures that the market function was not so much consolidated as curbed by the state apparatus. Pyongyang was concerned over the likelihood of erosion of its ideological foundation as a consequence of the free flow of resources and information in the open market. Since common belief in economic and moral superiority of socialism over capitalism constituted a fundamental commitment that the socialist bloc had shared (Kornai 1995), Pyongyang would not tolerate a situation where the superiority they have affirmed since the establishment of the DPRK was threatened.

Pyongyang, as a consequence, failed to prove that the 2002 blueprint was not merely stopgap measures to cope with its decaying economy after the great famine. The skeptics, for these reasons, concluded these economic adjustment attempts were not a priority in the statecraft of the DPRK in 2002. They argued a series of economic adjustments were designed not to liberalize its command economy system but to tentatively slow the likely erosion of their economic system.

These two viewpoints are not mutually contradictory. Whereas the former focused more on the expected effects of the economic changes of the DPRK, the latter put centrality on the fundamental intention and aim of the North Korean actions taken. The former in this context accepted the 2002 measures as at least a first step introducing market-oriented 'reform' and the latter understood it as a mere 'adjustment' attempt within its planned economy. However both underestimated the possibility that 'adjustment' meant developing toward 'reform' in a socialist economy (Lee M.C. 2006, 61-62). Instead of discarding one of the two contending perspectives, this chapter will pay intensive attention to the common elements that existed in the two theses by

exploring the longer history of economic changes in the DPRK. Decentralization, open-door policy, and pursuit of profit could be agendas that were located in the common area between the 'adjustment' and 'reform' arguments. Even those who dismissed the reform arguments agreed the DPRK pursued decentralization in the domestic economic policy and the partial opening of its economy to external capital well before 2002 (Hong I.P. 2002, Lee J.C. 2002)

### ***6.3 History of reform***

This section will discuss a range of reform ideas experimented in the DPRK for a few decades since the 1980s. These ideas included partial decentralization in production/distribution/budget, attempts to attract foreign capital, and constitutional revision and so on. This section will particularly focus on the change in the central party control system in the DPRK.<sup>45</sup> As Lavigne (1995) put it, loosening of party control was one of the most salient elements explaining economic reform in a socialist regime. Moreover, gradually loosening party control could be regarded, in the historical context of the DPRK political system, as an easily-embarked step to test, without causing a major shock to its closed system, how autonomy and discretion outside central command would work within their own system. This section will argue, on the basis of the historical examination of the North Korean efforts for decentralization, that the efforts laid a foundation, albeit it was not as successful as intended, for the announcement of a sweeping reform package in 2002.

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<sup>45</sup> Since the focus of this chapter will be the reform signal from the DPRK to South Korean entrepreneurs in terms of inter-Korean trade, other reform areas in 2002 blueprint such as pricing reform and foreign exchange rate adjustment will not be dealt with in this chapter.

### *Open door policy : 1980s*

The central planning agency in the DPRK made a variety of attempts for the decentralization of economic management throughout the 1980s. They included assurance of relative autonomy of the state-owned enterprises and promotion of foreign direct investment. The North Korean system for enterprise management since 1961 has been known as the Tae-an Management System (TMS). The Tae-an system was so named when the then North Korean leader Kim Il-Sung offered on-the-spot guidance at the Tae-an Electrical Factory in South Pyong-An Province.<sup>46</sup> Under the Tae-an system, the Korean Workers' Party retained supreme and dominant control over the North Korean industrial management by establishing Party Committees in the individual factories. The introduction of this collective management method as a new underlying system for the North Korean industrial production was understood as an action to deviate from the Soviet-type manager responsibility system (MRS) (Lee K. 1992, 950-952).

The most striking change in the North Korean economy in the 1980s was the so-called 'campaign for production of people's commodities' initiated in August 1983. The central planning agency demanded production units in the frontline factories manufacture goods independently without recourse to central supply of materials and parts. The center encouraged the frontline units to recycle locally available resources such as scrap materials. The agency also condoned the exchange of parts and materials between factories to promote such independent production. The production based on the autonomous material sourcing led to the creation of an unofficial marketplace in which

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<sup>46</sup> On the details of the Tae-an system, see Hong S.J.(1998) and Lee, H.S.(2001)

individual manufacturers participated. Moreover, according to an interview with a former North Korean factory worker, completed goods could be even transacted on the black market at a price determined not by the planning agency but by the demand and supply of the participants (Yang M.S. 2003, 35-54) Although the campaign stemmed from the supply shortages held by the central planning agency in the 1980s, the production and transaction of goods outside central planning led to expanded autonomy for factory managers. Some watchers described this move in the DPRK as 'the 1980s hidden reform' (Lee H.S. 2000, 52).

Another attempt to ease the centralized economic management system was made in the foreign economic relations of the DPRK. The DPRK promulgated a Foreign Joint Venture Law in 1984<sup>47</sup>. Unlike Pyongyang's firm stance not allowing cross-border capital transactions, the Law opened the door for Western capital to establish a joint venture on North Korean soil. The DPRK embarked upon this new experimental opening to the capitalist world with the purpose of attracting foreign direct investment. Yet it was not successful in attracting as much Western capital as they had hoped by enacting this law. The overwhelming majority of the established joint ventures were financed with pro-North Korea Japanese capital. Pyongyang still showed no favorable attitude in accommodating the capitalist management system even in the agreed joint ventures (Koh H.W. 2002, 96-97). Critics said that Pyongyang was only interested in acquiring new technology they needed from advanced economies while demanding Western capital on North Korean soil follow the strict rules of socialist planning system, which was highly unrealistic (Lee J.C. 2006, 21-22). Regardless of how far their

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<sup>47</sup> On the details of the Joint Venture Law, see Kim, C. (1988).

attempts were successful, the more significant ramification of this experiment was the change of North Korean perceptions on its long-standing *Juche* ('self-reliance') ideology. Namely, the DPRK openly admitted the fact that its *Juche*-based autarky economy could no longer provide the communist system with the driving force for growth and development. Given the findings that economic and political change had a strong correlation especially in the communist system (Eckstein 1970), the North Korean move for economic change should be understood as a political step signalling further opening of its isolated economy. The DPRK authority in the 1980s, in other words, began to seek a coexistence of openness and self-reliance by embracing the notion of 'interdependence' as a part of their anti-dependency modernization strategy (Lee J.C. 2006, 10-11). In the so-called 'modern imperialism theory' promulgated in 1987, Kim Jong Il went further when he insisted that the socialist economy could coexist with imperialism as long as both systems constructed a 'fair' economic order (Suzuki 1994, 240-45). A series of new initiatives for economic opening in the 1980s became an overture for the bolder approach in the 1990s.

#### *More autonomy: 1990s*

The introduction of an independent enterprise budget system represented the transformation of production and distribution mechanisms in the DPRK economy in the 1990s. Although there were occasional mentions of how to encourage the formation of an independent enterprise budget in the North Korean literature, until the 1980s, there appeared to be a wide gap between the statement and practice. It was in the 1990s that

the independent system gained widespread responses in the frontline enterprises. The key feature of the new system was the introduction of the notion of freely-disposable surplus which would be subject to the managers' decision. Under the new independent system, the local production units were allowed to keep the earnings from the sale of goods that overfilled quotas demanded by the central planning agency. The surplus could be disbursed for the purpose of either wage increases or more output in the next fiscal years (Yang M.S. 2003, 49-52).

In the 1990s, another pioneering experiment was made with regard to the DPRK's foreign economic relations. The DPRK set up the first foreign economic trade zone (FETZ) in its history in 1991, located in a 621 square kilometers region in the Najin-Sonbong area in the northeast corner of the country bordering China and Russia. The DPRK leadership made an announcement of the 3.3 billion USD initiative, with construction planned to be completed by 2001 to solicit foreign investment from the capitalist countries. By the end of the 1990s, however, only a few small-scale foreign investments in motorways, hotels, and telephone lines had been made. The completion date for the first phase of the regeneration plan was postponed indefinitely (Oh and Hassig 2000, 64).

A series of attempts in the 1990s to stimulate the paralyzed economy by providing frontline units with more economic autonomy within at least a limited realm were not successful. It showed that the lack of internal system transformation in economic management and the stubborn attitude to keep a fenced-off type of extremely limited economic opening were decisive obstacles in bringing about the required outcome. However, at the same time, it also suggested the DPRK leadership perceived the

necessity for the economic engagement policy with the foreign capital as an indispensable factor in order to overcome chronic underdevelopment. Kim Jong Il's statement below signalled such a perception change in the 1990s.

Developing foreign trade is not contradictory to economic self-reliance. It was rather to consolidate the independent nature and strength of our national economy. It was to facilitate the modernization and scientification of our national economy. Even a well-developed economy cannot prosper without exchanging materials that are lacking with many foreign countries that retain them (Kim J.I.1988, 344).

The mood of economic reform heightened again when the DRPK revised its constitution in 1998 for the purpose of accommodating the notion of private ownership. The DPRK leadership aimed at strengthening the power of the technocrat-laden Cabinet in economic management with this constitutional revision by granting it greater policy autonomy from the paramount doctrine of the Korean Workers' Party. Technocrats in charge of economic management were also freed from the oversight of the Central People's Committee, the Party's main decision-making body. Instead, local government became responsible for managing light industries and cooperatives, with cabinet ministers remaining in charge of the heavy industrial sector (Guo and Stradiotto 2007, 766). The constitutional reform, as a result, led to the enactment of the Processing Trade Act in 2001 and also laid a foundation for the economic decentralization measures announced in 2002.

#### ***6.4 Reform package in 2002***

The reform ideas and a series of subsequent measures to enhance economic efficiency in the 1990s were significant moves challenging the dogmatic application of *Juche* ideology to economic affairs. Although there was little evidence that the reform experiments brought about a structural transformation of the DPRK economy, one point should not be denied. The sweeping economic reform measures announced in July 2002 existed in the continuity of core ideas that flowered in the 1990s or beforehand. The unsuccessful reform attempts during this period, in other words, underpinned the comprehensive measures for the reconfiguration of the DPRK economy.

On the other hand, the DPRK authorities began to curb transactions in the newly-appeared farmers markets from about 2006. They took precautions against the perceived drift toward capitalist type of transactions. From 2006, they began to make an attempt to limit the age and gender of the traders entitled to sell their own products in the farmers market. They also banned the discretionary employment of factory workers. The official authority to supervise inter-Korean economic cooperation was transferred to the Party from the Cabinet organization in 2007 (Park H.J. 2008)<sup>48</sup>. The economic reform mood in the DPRK, in this respect, peaked between 2002 and 2006.

This section will particularly pay attention, among a set of reform measures announced in 2002 and developed thereafter, to decentralization and the notion of profitability. The section will argue these two elements brought about the notion of private interest of North Korean trade companies and in turn led to promoting trade with

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<sup>48</sup> The planning and implementation of the domestic and foreign economic policy by the Cabinet ministries implied a more flexible approach than the ones by the Party organizations in the North Korean economy. For further discussion, see Carlin and Wit (2006).

their South Korean counterparts. Consequently, inter-Korean trade was hypothetically affected by this changed environment in terms of the trade companies' attitudes seeking more profit, which had not been essential in the centralized command economy in the past.

### *Decentralization*

Decentralization in a socialist economy should be understood as a purposeful endeavour of the central government to enhance the efficiency and productivity of its economic management. Decentralization could be divided into administrative decentralization and economic decentralization. Whereas the former refers to the central government's attempt to hand over its right to set up rules to the local government, the latter means a series of processes in which the right went to the factories and enterprises level from the central planning agency (Schurmann 1968, 175). The decentralization, in order to achieve more productivity and efficiency, should be pursued systematically and simultaneously in the two fronts. By doing so, it aims to gain a diversification in economic management and a greater autonomy of non-central units in the economic decision making.

What needs to be emphasized here is the fact that the purpose of decentralization prior to substantial transition of the socialist economy was not to equip a political drive aiming at democratic development. It was constrained within the willingness to more efficiently operate the existing socialist regime. The pursuit of decentralization should

therefore be understood as a top-down effort by the regime leadership to make its system more stable (Lee M.C. 2003, 47-55).

Given such a purpose of decentralization, one could find the key logic of the North Korean reform program well before the central government made the announcement of official implementation in 2002. The following statement made in 2000 in the North Korean literature provided one example.

Under the condition that the inter-relationship of production and consumption between factories and enterprises became complex and diversified, a state will neither be able to set up concrete production guidelines for every unit nor need do so. While directing the state guidelines to the implementation of major tasks, it is important for factories and enterprises to creatively pursue economic management activities under overall state planning (Kim M.C. 2000,15).

The socioeconomic move for decentralization observed in the DPRK was not in this sense incompatible with the planned economy the regime had maintained since the establishment of the nation in 1948. The move could be interpreted as one axis of the 'hybrid system' or the 'dual structure' (Frank 2005a). The concept of 'second society' by Hankiss could also be useful in interpreting the simultaneity of a centrally planned economy and the shift of decision making power into the local units in the DPRK after 2002. Hankiss recognized the parallel coexistence of a first society having a formal and institutional nature and a second society characterized by an informal and private realm

in a socialist economy (Hankiss 1988, 22). If one borrows the notion of second society, it could be said that the DPRK leadership condoned the *de facto* development of the second society which had spread in the black market due to the collapse of rationing system after the famine in the 1990s.

In the announcement of the reform package in 2002, the DPRK central government made a decision to devolve its own right for production and distribution, at least in part, to local production units. The central government would plan strategically significant industries while letting other enterprises and factories work out their own plans within the framework of the overall state planning. By decentralizing the decision-making procedure and separating the local economy from the central planning, the local governments and the relevant sub-organizations were permitted to determine their own production targets and prices. This change accordingly encouraged inter-organizational competition for the purpose of gaining more profit. As a result, a growing number of enterprises used their own capital and bank loans to cover operational costs (Cho D.H. 2003, 141).<sup>49</sup> A financial deficit even led to the resignation of the manager of a particular enterprise, according to the testimony of North Korean escapees who left the DPRK after 2002 (Yang M.S. 2003). The political right to control and administer production used to be exclusively exercised by the relevant Party commissions. But it was partly devolved to the frontline managers of the enterprises and factories in 2002. The role of the Party secretary was confined to offering political guidelines.

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<sup>49</sup> As China's reform experience suggested, enterprise reform in socialist economy was as crucial as pricing reform, as long as it aimed to introduce at least in part the market principle. Lagging enterprises could not respond appropriately to the market signals created by the redesigned pricing system (Liu 2007, 18).

Additionally, a new accounting system was introduced in 2003 to reflect these changes on the balance sheet. The ultimate goal of the DPRK enterprise in the relevant law was officially turned in this year from 'cost reduction' to 'net income increase' (Kim Y.Y. and Choi S.Y. 2005, 24-26).

Nevertheless, the central authorities still retained the ability and power to make a number of management decisions. It included decisions on salaries, promotions and demotions, and employment reductions (Guo and Stradiotto 2007, 767). 'Collectivism' and the Party leadership were still the first and foremost elements in economic management in the DPRK (KWP 1999, 419-421).

However, further decentralization was announced in 2004 to give frontline managers more powers to tackle these issues. By this additional step, the managers in several selected enterprises could get involved in the more crucial management decisions such as fixing wages and hiring of new workers (Kim Y.Y. and Choi S.Y. 2005, 24-26)

A series of decentralization measures implemented after 2002 consequently resulted in real changes in terms of the practice of the North Korean trade organizations. This was because the decentralization required the local units' responsibility as well as giving them more expanded autonomy. South Korean entrepreneur, Yu Wan Young (2008) who maintained his business with North Korean counterparts under the second nuclear crisis witnessed the remarkable change after 2002.

The North Korean trade units had no choice but to make their own way for survival as the central authority required material sourcing by their own

efforts and profit creation without recourse to full-scale assistance from the central planning agencies. They seemed to be more active in engaging with their South Korean counterparts under the changed environment. In other words, North Korean trade companies were required to create external money sources by strengthening their trade channels with South Korea simply in order to survive in the new political and economic climate.

Under the newly-built center-local unit relationship, the conventional command-obedience structure in the planning economy underwent a remarkable change. As Kornai stated that negotiation supplanted command in the early stage of the socialist reform (Kornai 1985, 489-490), there was a certain level of dissent between the central planning agencies and the frontline trade units in the post-reform period in the DPRK. Yu Wan Young (2008) also stated,

Even if the planning agency ordered a trade company to make a transaction with supplier 'A', if the company predicted more gain through a 'non-A' supplier in a third country like China, it did not adhere to the guidance by the agency. The command-obedience relationship between the planning agency and the trade company collapsed.

The primary factor that caused the relationship change was the desperate need for profitability in managing trade companies. The emphasis on the profit motive in

the 2002 reform package also required a greater role for enterprises in the overall economic planning.

### *Profit motive*

The goods in the spontaneously built farmers markets were largely traded at free-floating prices. The response of the central authorities to this grass-root market was tacit approval in the first place. It recognized its contribution in making up for the state's inability to maintain a food rationing system. Pyongyang later legalized the farmers market and allowed freer transactions within a designated place in the capital as well as some of the major cities and towns.

The combination of greater autonomy in production planning and the emergence of selling outlets for surplus goods encouraged the North Korean people to pursue more profit. The industrial goods outside the central agency's plan, after fulfilling the state quotas at predetermined prices, could be sold at more flexible market prices (Kim Y.Y. and Choi S.Y.2005). In this production and distribution pattern, the key element to stimulate a profit motive was the performance assessment by so called 'real income' (called '*bon-sooip*' in Korean). By introducing the new assessment tool, the real income index began to replace the old notion of 'production index' in the DPRK industries.

Before the 2002 reform, the DPRK planning authority had assessed the performance of the enterprise only by measuring what it had produced based on a physical quantitative index such as tons and meters. The paramount aim for the enterprises was to meet this state quota no matter how much it would be cost-effective

and how many articles could be sold on the market. However, after 2002, the planning agency began to encourage enterprises and factory managers to create more profit while stressing less the quantitative production plan. This could be achieved by either of two new approaches : lower production costs or bigger turnover. As ‘real income’ (*bon-sooip*) was defined ‘aggregate income by sale – production cost + wage’, under the condition of an equal wage level, bigger sales or lower costs implied an increase in ‘real income’ (*bon-sooip*) (Ahn H.C. 2003, 41). The changed assessment criterion helped the new concept burgeon in the behavior of North Korean enterprises and factory managers. The monetized economy began to supplant quantitative planning as a result (Newcombe 2003). They had to pay more attention to more efficient production management or the possible cost reduction strategy to maximize their ‘real income (*bon-sooip*)’, which had not existed before 2002.

Given that the socialist economy in the USSR and many Eastern European countries had faced serious similar incentive problems that hampered efficiency and stifled innovation, such a step that emphasized ‘real income’ (*bon-sooip*) was considerable progress. Profit as a main economic motivator subsequently resulted in fostering a more incentive-based economic management at the level of enterprise. In terms of inter-Korean trade, the introduction of a comprehensive incentive system catalyzed North Korean economic units to engage more with South Korea to find alternative sources of profit outside the paralyzed North Korean economy (Chong, K.I.2009). The payment of employees was tied more closely to the performance of the enterprise in the post-reform North Korea. The wage gap between workers, for example, widened depending on their skill level (Cho D.H. 2003, 134-35). As Kornai argued that

firms' success should be measured by profits in the post-reform socialist economy (Kornai 1992, 45), the widespread expansion of the profit motive in the DPRK's official economy reconfirmed that the 2002 package produced an outcome they had desired.

There were some episodes that showed how the profit motive changed the practice of North Korean economic organizations in terms of inter-Korean transactions. South Korean businessman Yu Wan Young said that

In the past, the North Korean host organizations did not care where South Korean visitors spent their money to shop for what they want. But after 2002, South Koreans were strongly recommended to shop only at the store with which the host organization maintained transaction records. This implied that the concept of kickback had begun to emerge between the stores and the quasi-governmental organizations.

All in all, the change in enterprise management in the DPRK not only influenced the domestic economy but its practice for economic transactions with foreign capital. The frontline economic units that maintained persistent contact with the South Korean counterparts seemed to realize that mutual benefit in trade was essential to make the business sustainable. In other words, the opportunity cost was expected to be occurred if the relationship between the two Koreas is disrupted. The vulnerability interdependence, in this regard, as one of the two key elements that constitute the notion of the interdependence in international relations (Baldwin 1980) began to emerge in inter-Korean relations. However, this did not imply that economic interdependence between

the two Koreas downgraded security concern in North Korean foreign policy in shaping its reaction to broader inter-Korean relations. It rather demonstrated the unilateral dominance of security in DPRK foreign relations was reduced as long as economic cooperation did not incur a direct security threat to its regime.

### *Trade promotion*

Other pioneering moves were observed in North Korean foreign economic relations. Since the early 1980s, the DPRK had adopted a more liberal trade and foreign investment policy in order to revive the isolated economy. The proclamation of the 'new trade regime' in 1992 helped the individual economic units including cabinet ministries and the local organs of the Party to invigorate foreign trade by abolishing the monopolistic standing of the central government in foreign trade. In this new regime, the central government permitted the Party, the Cabinet, the military, and other individual economic organizations to run their own trade companies. The number of trade companies across the DPRK as a result dramatically increased. Despite official emphasis on central control by the leadership, since the early 1990s, the North Korean trade system was in effect decentralized in the wake of the introduction of the 'new trade regime' (Lee M.C. 2003, 174-75). The diplomatic normalization with many European countries from 2000 to 2001 and accession to the ASEAN Regional Forum (July 2000) reflected the government's attitude change on the necessity of creating a more inviting environment in order to attract capitalist investment. The DPRK government made threefold efforts to promote international trade : institutional

reorganization, the devaluation of the North Korean *won*, and the designation of special trade zones.

The diminution of the trade monopoly by the central government became clearer as individual Party subunits and Cabinet ministries began independently to run trade companies as major sources of foreign currency. Although all the trade companies across the DPRK were under the control of the Cabinet in principle, the trade transactions by these companies were in effect made independently. It should also be noted that there were many trading companies not belonging to the Cabinet ministries. They were under control of the Party units and special organizations like the intelligence agency, which had been enjoying exclusive and privileged power. For example, Chong Kwang Il (2009), a former branch chief of *Chosun-Pyongyang* trade company who defected from the DPRK in 2003, stated that non-Party affiliated, underprivileged trade companies could not reach out to South Korean businessmen. His company affiliated with the Pyongyang city government, for this reason, was not able to open transactions with South Koreans as it was listed as a so-called 'social organization', not a 'party organization'.

There were data showing that the number of trade companies rose to seventy-one as of the early 1990s, an even greater number than those of China and the Soviet Union when they had embarked on economic reform. A dramatic increase in the number of trading companies, which were not entirely controlled by the central leadership, was a sign that confirmed the decentralization in the DPRK economy was undertaken not only in the production management and distribution but in foreign economic transactions. The growing number of trading companies in the DPRK did not mean the advent of a

liberal trading order. It rather reflected the growing desire for the Party and many other power groups to secure foreign currency by possessing their own foreign trading channels. In this sense, such a trend was interpreted as a disorder to seek individual economic rent far from the essence of socialist planned economy (Ko I.D. et al. 2008, 261-305).

However, it was certain at the same time that the pursuit of trading companies to build up channels with their own counterparts consequently affected patterns, channels, and frequency of communication between them and external partners. It created competition between the companies, and the external counterparts were prepared to reap benefit from that competition. One of the main potential beneficiaries was no doubt the South Korean traders who began to encroach on North Korea's heavy trade dependence on China.

The most striking change in the DPRK trade policy after 2000 was its ever-increasing dependence on the trade with the ROK. The determined will of the DPRK government to further inter-Korean economic cooperation to earn foreign currency was expressed once again when it established the National Economy Cooperation Commission (NECC) in July 2004, which would control the existing National Economy Cooperation Federation (NECF) on behalf of the Cabinet. The NECC grew into a key organization responsible for overall planning and control of inter-Korean economic cooperation after that (*Dong-A Ilbo*, 10<sup>th</sup> April 2009). The North Korean authorities also showed great confidence for a bold approach to precipitate the process of handling foreign economic transactions. Their commitment was openly made in the investor relations event organized by the NECC in Pyongyang (*Hankook Ilbo* 4<sup>th</sup> October 2005).

The emphasis on international trade by the DPRK government was followed by the devaluation of the North Korean *won* in 2002. As part of the reform package in July 2002, the DPRK government abandoned the artificially high value of the *won*, depreciating the currency from 2.2 *won* to 150 *won* to 1USD. The devaluation aimed at attracting foreign investment and providing export incentives for domestic firms (Guo and Stradiotto 2007, 767). The devaluation of the domestic currency in the socialist transition economy must be large enough mainly for two reasons. One is to generally improve the trade balance and the other is to avoid the subsequent inflation expectations in case the initial devaluation was not credible (Lavigne 1995, 138-39). Given this past experience of East European countries, the sudden devaluation of the North Korean *won* was a big enough step to stimulate the planned trade promotion. It was particularly true given the similar currency exchange rate adjustment of Chinese *renminbi* against the U.S. dollar during Chinese economic reform in the 1980s and the 1990s (Liu 2007, 15-16).

While the reform package in July 2002 was aimed primarily at revitalizing the domestic economy, the designation of the special economic zones was part of an open-door policy to attract more foreign capital. The DPRK revealed an ambitious plan to proclaim special economic zones in which foreign capital and labor could be part of the economic activities in a freer environment. The zones included Kaeseong, Shineuiju, and Mount Kumkang. The limited economic experiment in the fenced off zone raised doubts about the genuineness of the DPRK's willingness to implement the sweeping openness (Smith 2005c). The designation of Shineuiju as a special administration zone in 2002 was clearly abortive. But this was not because of the isolated nature of the

region, but because the premature attempt was not concerted with Beijing which did not want to permit a capitalist wave in the very city on the border between the DPRK and itself. Except for the Shineuiju case, the Kaeseong and Mount Kumgang projects, at least from 2002 to 2006, were fruitful in terms of a deeper engagement with the ROK and subsequent foreign currency influx.

As a result of the measures taken to promote international trade, the DPRK economy was able to have an opportunity to understand the notion of the regional division of labor. The trade promotion initiative induced the DPRK authorities to make use of comparative advantage rather than producing everything domestically to meet the people's needs (Liu 2007, 14). As Choi Young Ok, a North Korean economist, asserted in 'Economic Studies (*Kyongje Yongu*)' in 2004, economic autarky was no longer on the agenda in the North Korean economy (Choi Y.O. 2004, 33).

### ***6.5 Result of survey***

Although there were historically accumulated experiences in the DPRK for a more open and flexible economy, the North Korean style experiment for economic reform showed little impact in improving its actual economic relations with the external world. This was also true when it came to its trade with South Korea. South Korean SMEs felt that the DPRK foreign economic policy still lacked predictability, which was an essential element for them establishing a long-term business plan. Moreover, they claimed that the state trading companies in the DPRK often made exorbitant demands in determining detailed condition of contract. Another complaint made by the South Korean traders included North Korean people's tendency to more emphasize

fraternalism rather than the commercial logic of transactions, which resulted in many South Korean traders giving up inter-Korean trade (SBC 2007, 34-41). This negative perception of the South Korean SMEs on North Korean economic practice was also shown in the survey results for this study.

To the question asking for the main factor that enabled South Korean entrepreneurs to maintain inter-Korean trade volume despite the nuclear crisis, nobody answered that positive expectations for the North Korean economic reform affected their decision. It showed a sharp contrast with the fact that the majority of the South Korean SMEs involved in inter-Korean trade were encouraged by the IKCF and the domestic business environment to push North Korean business forward. It showed that the South Korean SMEs were more responsive to the domestic (push) factor and much less receptive to the external (pull) factor in making decisions on inter-Korean business. Another question to investigate whether the North Korean economic reform package influenced the South Korean entrepreneurs' decision-making in general also showed that its impact was not as significant as the other push factors. Only 27% of the respondents said the move of economic change in the North influenced their decision in the South. This was slightly lower than the government's subsidization (31%) and much lower than the domestic business environment (54%).

Even before 2002 the North Korean leadership conducted plenty of policy experiments aiming to revive the domestic economy and foreign economic relations. The decentralization of economic power both in the domestic realm and international trade was central in these initiatives. Under the initiatives, the profit motive was introduced and the greater power was given to factory managers to facilitate more

production. Therefore the South Korean business community who had actually engaged in the North more during this period than any other previous time seemed to accept a set of reform measures in the North significantly promising to promote inter-Korean economic links. As Nye earlier elaborated, a more equal level of development leads to a higher level of economic ties between actors (Nye 1970, 815-18). The South Koreans might have high expectations that they could find a highly desirable potential partner which could replace low-cost production in China or Vietnam. However, as shown in the results of the survey, the change in the North failed to influence the willingness of the business community in the South for more engagement with themselves. The only noticeable contribution of the continued experiment of trade reform to the invigoration of inter-Korean trade came from the creation and activity of a quasi-governmental organization such as the NECF and the NECC as a fast-track trade promotion channel, which will be discussed more in chapter 7.

## ***6.6 Conclusion***

The agenda of North Korean studies in the area of international relations has largely been dominated by how to interpret Pyongyang's 'diplomatic' signals in terms of its provocative and 'non-diplomatic' actions. The continued 'tit-for-tat' style nuclear confrontation since 1993 fostered such a bias in which the vast majority of the scholars and analysts paid overwhelmingly more attention to this pendulum of the diplomatic game. The endogenous development of the North Korean strategy to revive its economy attracted less attention until Pyongyang made an announcement about the market-friendly reform package in 2002. Despite intensive debate on how to interpret the reform

initiative, few pundits dealt with how the internal reform affected its external economic relations. As the volume of the DPRK's economic transaction with the ROK significantly grew from the 1990s, there was a growing need in the South to analyze and predict the direction where the North intended to proceed. As a result, the causal relationship between the attempts to realign the domestic economy in the North and its ramifications in the South became worth analyzing.

This chapter investigated how and why the DPRK introduced and developed the reform ideas since the 1980s in domestic and external economic relations. By doing so, it attempted to find out to what extent the move of the economic reform in the North affected the behaviour of the business community in the South in terms of inter-Korean economic engagement. Firstly, this chapter concluded that the North Korean economic reform package announced in 2002 was developed from the earlier version of the adjustment policy in the 1980s and 1990s pursued with the purpose of containing the decreasing productivity. The adjustment program ranged from the decentralization policy, giving more power to the frontline manager group, to the open-door policy to improve external economic relations. The DPRK authority also introduced the notion of the profit motive in most production units in order to boost production. Secondly, the result of the data collected through the survey showed that the reform signals from the North during 2002-2006 had little influence in changing the pattern and volume of inter-Korean trade in this period. The North Korean reform package had a considerable pre-history and held enough potential to be developed to the marketization of the production and distribution mechanism. Yet the survey results suggested that the positive signal for more profit-oriented economic environment in the North failed to transform external

watchers' perceptions expecting its willingness for more audacious reform. Although there was some anecdotal information which showed a more flexible attitude of the North Korean frontline trade partners after the reform announcement, it did not lead to an overall perception change toward the practice of North Korean trade with the South.

This chapter rejected the argument that the North Korean reform package was designed simply to disguise its ailing economy with pseudo-reform measures. The chapter rather supported the idea that the package and the subsequent expansion of the reform ideas proved that the reform drive in the economy could be compatible with the North's military provocation in politics which was still intact under the Kim Jong Il leadership, which was previously denied by some scholars (Noland 2000, 348). But, at the same time, the chapter also challenged the account that the reform *per se* strengthened the interdependence between South and North Korea. A closer relationship between states depends more on their expectations of future trade relations and not necessarily on the degree of the current interdependence (Copeland 1996). In this regard, this chapter concluded that the future of the inter-Korean trade was still unclear despite the reform mood from 2002 to 2006 in the North that signalled closer economic ties between the two Koreas.

## CHAPTER 7

### Domestic Business Conditions in the ROK

#### *7.1 Introduction*

This chapter will argue that the domestic business environment in the ROK constituted a key causal variable to explain the increasing trade volume between the two Koreas during the nuclear crisis from 2002 to 2006. This chapter is organized into five parts. The first part will briefly point out the under-researched nature of South Korean SME-related studies with focusing on manufacturing industry in difficulty. The second part will highlight the predicament of the South Korean SMEs from the 1980s from a variety of angles. This part will reveal the nature of the SMEs crisis in the ROK manufacturing industry in terms of their competitiveness in production costs. It will show how seriously the business community treated the worsening production environment in South Korea. The third part will address the South Korean SMEs' attempts at overseas production in an attempt to reduce soaring production costs. This part will show the rising obstacles from production in China and Vietnam followed by the major benefits of the inter-Korean economic engagement many SMEs expected. The fourth part will show the benefits and risks the South Korean SMEs could encounter through business with the North Korean counterparts. This part will suggest various elements by which the South Korean businessmen are likely to make a decision on whether they would increase or decrease their business volume in association with the

DPRK. The fifth part will analyze the survey results which showed how the South Korean SMEs reacted to the growing nuclear tension in the Korean Peninsula with the special focus on why they increased their trade volume with the DPRK between 2002 and 2006.

## ***7.2 Studies on the South Korean SMEs***

In tackling cross-border production and distribution, SMEs should be understood in a different perspective from a range of theories that explained the global sourcing and manufacturing by multinational companies. A range of studies on the global production networks by corporate giants that dominated world oil, mineral, and agricultural products was central not only to international economics studies but also international relations theory (Held 2000, 236-82, O'Brien and Williams 2004, 167-223, Lairson and Skidmore 2003, 347-372). In contrast, the studies focusing on the attempts to exploit overseas manufacturing outposts by SMEs, in pursuit of cheaper labor and facility costs, were omitted from mainstream IR studies. The situation in the ROK had many similarities to this. The South Korean SMEs that sought alternative production facilities and workers in North Korea were not multinational firms which had a range of outlets or subsidiaries across the globe. They were largely low-profit manufacturing firms that had struggled to survive due mainly to the rising labor, land, and facility costs in the ROK since the late 1980s.

Many South Korean scholars who studied the reality of the South Korean SMEs in the 1990s and 2000s, in terms of their internationalization strategy, paid greater attention to the prospect for fostering Silicon Valley-style information-technology (IT) based

innovative companies as a new business model (Hong S.T. et al. 2001 Bae J.W. and Bae J.T. 2003, Yang Y.S and Lee J.H. 2004). Having been stimulated by the Kim Dae Jung administration's strong encouragement for small business to get involved in IT related industries, the mainstream research trend on SMEs largely turned away conventional manufacturing industry. The worse the plight of the South Korean SMEs became, the less research was conducted in this respect.

### ***7.3 Business conditions of SMEs in the ROK***

This section will show the vulnerable standing of the South Korean SMEs in the 1990s in connection with the changed business environment in the domestic economy of the ROK. To do this, the section will firstly highlight the unevenness between *chaebol* and small and medium sized manufacturers in terms of the South Korean government's industrial development strategy. Secondly, it will show the disadvantaged position of conventional manufacturing industries after the economic crisis in 1997, which further reconfigured the South Korean industrial structure.

#### ***Standing of SMEs in the ROK***

The South Korean SMEs began to lose their international competitiveness from the late 1980s. The strong pressure from organized labor unions, while being chased by other underdeveloped Asian economies, made a low-wage based business strategy no longer viable. Particularly labor-intensive manufacturing industry with a low technology level was hit worst by the changed environment.

The wage pressure caused many SMEs serious difficulties in securing enough workers to meet their production targets. Low wages offered by the SMEs could not satisfy potential workers' demands. Thus it led to chronic shortage of workers in the relevant industries. One survey conducted by the Korea Federation of Small and Medium Businesses (KFSMB) in July 2004 showed that the majority of the South Korean SMEs singled out 'relatively low wage' (41.1%) as a primary factor that hindered them from securing sufficient workforces. The wage concern was followed by 'unsafe working environment' (28.7%) and 'distorted reputation for the small business workers' (29.3%). The South Korean SMEs in the labor-intensive manufacturing industry, as a result, underwent continued shortage of workers despite the overall redundancy of workers and insufficient job opportunities across the South Korean economy. According to the interviews of employers in the survey above, 42% of the respondents answered they lacked the workers required (KFSMB 2004).

Lack of satisfaction as SME workers in terms of wage level coupled with vulnerable welfare schemes led to an unstable employment situation. The survey of the average length of employment of manufacturing workers demonstrated more frequent shifts of SME workers than in larger companies because of their continuous search for higher wages. More than 50% of manufacturing workers in South Korean SMEs continued to work less than three years on average in a chosen company according to the survey in 2004. As a consequence, the calculated rate that indicated the shortage of workers for the South Korean SMEs rose from 0.7% in 1998 to 9.4% in 2002 (KFSMB 2004).

The shortage of workers whom the SMEs could afford to pay forced many small businesses to shut down their production facilities. Many SMEs could not meet their production target simply because of the shortage of workers even though they had a full line of facilities. Whereas the auto-making and the shipbuilding industry led by a handful of *chaebols* showed improved trade balance, other industries where SMEs accounted for higher proportion, for example, footwear, apparel etc. recorded continued trade deficits according to the KITA. The entrepreneurs who actually undertook individual business in the increasingly tough South Korean domestic market also expressed pessimism about the outlook of their business. The survey result by KFSMB conducted in July 2003 demonstrated that 86% of the respondents out of 278 CEOs answered that their business was in 'crisis'. In contrast, only 7.2 % of the CEOs among those who were surveyed expressed optimistic views on the same question (Lee K.S. 2003, 4-5).

### *Chaebol vs SMEs*

The predicament of the SMEs becomes clearer when contrasting them with the South Korean *chaebols* that enjoyed governmental support in terms of allocation of financial resource as well as a range of deregulation to nurture strategic industries. One research showed that the relative labor productivity of the workers in the SMEs, compared with that of large companies, plummeted from 53.7% in 1980 to 28.8% in 2002. In parallel with this increasingly low productivity, the per capita annual income of

the SME workers in comparison with the *chaebol* also dramatically dropped from 84.2% in 1980 to 49.9% in 2002 (Chung Y.S. et al. 2005, ii).

Being motivated by the deepened polarization between the *chaebols* and the SMEs, the ROK government announced a series of policies that stressed the role of the SMEs to accomplish balanced economic growth. As a result, cooperative role-sharing and joint development of innovative technologies, and fairer deals without acknowledging the *chaebols*' vested interest were emphasized to forge equality between the *chaebols* and the SMEs (Chung Y.S. et al. 2005, Lee K.S. 2003). Nevertheless, the vulnerable standing of the South Korean SMEs remained largely unchanged even after the economic crisis occurred in 1997 where the *chaebol*, built on its 'high debt model', had been singled out as a primary cause of the economic meltdown of the ROK.

#### *After the IMF Crisis*

The extensive economic crisis initiated in 1997 exposed a highly vulnerable economic structure in most of the corporate sectors in the ROK. Rising labor costs were pointed out as one of the many factors that resulted in the low profitability of both small businesses and state-sponsored *chaebols* (Kim J. K. and Lee C.H. 2002). All the companies in the market were accordingly forced to build a higher profit-oriented, cost-down structure. The *chaebols* at the same time faced strong government regulation with regard to their financial soundness such as debt ratios. A new cohort of small businesses armed with strong computer-based technologies emerged as an alternative form of strategic industry as the octopus-leg style diversification strategy by the *chaebols* was no

longer supported by the government. These computer and digital technology-driven small companies changed the conventional image of the South Korean SMEs (Park H.J. 2002). One comparative study on the South Korean SMEs before and after the 1997 crisis clearly demonstrated the transformation of their business structure after the crisis. They achieved a more technology-intensive business model with strong financial backing from domestic and foreign stock markets after the crisis (Yang H.B. 2002).

The labor-intensive manufacturing industry, however, was far from this new development of the SMEs. A survey by KITA in February 1998 showed that 93% of 40 companies surveyed were badly affected by the 1997 financial crisis. The sharp decline in domestic demand caused by the economic recession and the high exchange rate (depreciation of the Korean *won*) further shrank the South Korean manufacturing industry heavily dependent upon import of parts from overseas. Unlike the industrial reconstruction in the realm of the SMEs in general, the conventional and labor-intensive manufacturing industry was rather marginalized. The attempt to seek alternative production sites overseas was an inevitable choice for the South Korean SMEs that had been struggling to survive in the changed domestic market.

#### ***7.4 Overseas production of the ROK SMEs***

China and Vietnam became the countries the South Korean SMEs primarily chose as alternative production outposts to escape from the increasingly tough business environment in the ROK. Geographical proximity and cheaper labor and land cost provided the struggling businesses in the ROK with the foremost attractive conditions.

However, as the benefits from production in these countries are falling, the small businesses began to seek alternative sites again in nearby areas.

One case study that analyzed the experiences of 42 South Korean companies in China showed that there were many obstacles to stable growth of their business. The problems varied ranging from the cultural differences in business practices to the increasingly heavier burden of social insurance for their employees in comparison with domestic investors in China. The vast majority of South Korean businessmen in China claimed that labor costs rose by up to 20% every year after 2000. They also pointed out that the Chinese government tightened up the preferential conditions which had been given to foreign capital. As well as decreasing benefits stemming from low labor cost production, they also appeared to feel increasingly higher pressure to provide their employees with a set of fringe benefits by the tougher government policy to protect domestic workers' basic rights (Han J.H. et al. 2005).

Another on-site survey conducted in four Chinese cities including Beijing and Qingdao showed the worsening business environment for the South Korean SMEs in China. According to this survey that involved 18 South Korean companies, although their output increased by 20 percent on average from 2004 to 2006, the net profits they reaped during the same period decreased on the contrary. Analysts who took part in this on-site survey pointed out the main factors that caused this discrepancy were mainly the increased production cost in China and the abolition of tax benefit from local government. What is more, 20-30 percent of the workers tended to leave for better conditions every year resulting in serious difficulties in recruiting new employees. This situation highlighted the relative preference of the KIC for the South Korean struggling

manufacturers to maintaining their business in China. The KIC had relative superiority in production in China, according to those who answered this survey, in terms of labor productivity, quality level of produced goods, and facility operation ratio (SBC 2008, 42-49). To make matters worse, the Chinese government announced a set of policies aiming to protect its own POC trade in 2006. The government lowered the tax refund rate which had been given to foreign POC traders and banned POC trade in particular products to protect domestic industry. The banned products list accounted for 6.5% of all the products imported from and exported to China (SBC 2007, 13).

Another case study on South Korean investment in Vietnam after the diplomatic normalization between the two countries in 1992 showed a positive outlook and a couple of limitations at the same time. The volume of ROK investment in Vietnam continuously grew and the ROK became the biggest investor in the former communist economy as of 2006. According to the study, however, the South Korean companies in Vietnam faced difficulties in terms of personnel management and recruitment of skilled factory workers. The difficulties in finding able supervisors on the production line and in infusing frontline workers with willingness for demanding tasks were pointed out as main obstacles. Shortage of local workers who are able to play a supervisory role to discipline and manage frontline workforce resulted in companies being forced to send more Koreans to Vietnam pushing up the overall production cost. The lack of an incentive system that has long grown under paternalistic communism was not changed. This continued socialist working culture in industrial development bred cronyism-based human relationships, widespread kick-back practices, and deep-rooted corruption. All

these past legacies created difficulties for South Korean businessmen in maintaining their production in Vietnam (Han J.H. and Yoon D.J.2007).

### ***7.5 SMEs and inter-Korea trade : benefits***

The existing IPE theory-based accounts of cross-border production were not able to capture the essence of continued or increased trade between the two hostile nations led by the small businesses in trouble. To explain what made the South Korean small businesses take the risk of political destabilization in the Korean Peninsula, one needs to pay greater attention to the perception of the South Korean business community as well as the mutually dependent structure of the South and North industry. From the experiences in the 1990s and 2000s, the South Korean small business community became well aware of the potential benefits from the business utilizing human and natural resources in the DPRK. But the reality was that they were not prepared to pursue this risky business without recourse to governmental efforts to remove any uncertainties.

The Small Business Corporation (SBC), a quasi-governmental organization to promote the SME business, conducted in 2000 a comprehensive survey to see how many companies had an interest in launching business in North Korea. According to this survey, 96% of the respondents out of 955 small and medium sized companies were optimistic in terms of the future prospects for inter-Korean economic cooperation. On the contrary, the majority (66%) of the survey participants were not aware of the detailed procedures and conditions of inter-Korean trade. As a result, very few companies (7%) turned out to be willing to embark on business with the DPRK in the near future but the vast majority (79%) remained lukewarm about doing so, saying they

only had a long-term plan to pursue inter-Korean business depending on how the political and economic situation changed in the future. They were extremely cautious in pursuing North Korea-related businesses on their own and still maintained 'wait and see' positions. The majority of them (69%) at best preferred collaboration with other companies in an attempt to minimize the likely risk from inter-Korean business which could arise in the initial stages (SBC 2000).

As this survey result showed, the perception of the South Korean business community before 2000 in terms of how to view inter-Korean business remained within the realm of unspecified and ambiguous likelihood. It lacked detailed feasibility analysis, thus realistic demands to immediately launch inter-Korean business were not made. However, wide-ranging change in the environments of inter-Korean economic relations was introduced as a consequence of the 2000 summit talks which began to transform the likelihood into reality. The realistic benefits that the South Korean SMEs could enjoy are summarized in four points. These elements also explain major features of inter-Korean economic transactions actually spearheaded by the SMEs.

Firstly, the South Korean small businesses that had struggled from the deteriorating production environment in both domestic and overseas factories such as China and Vietnam expected that economic transactions with North Korea would create an alternative solution to survive in a more competitive business environment. As Tables 7.1 and 7.2 show, the wage level in the KIC initiated in 2000 by the Hyundai-DPRK agreement was significantly lower than that of China, Vietnam, and Indonesia let alone the ROK.

Table 7.1 Comparison of wage levels in Kaeseong, China and the ROK

(Unit : USD)					
	Kaeseong(A)	China (B)	ROK (C)	A/B	A/C
Minimum wage (per month)	50	100-200	642	0.29-0.58	0.12

Source : SBC (2005)

Table 7.2 Comparison of wage levels between the DPRK and other Asian countries

(Unit: USD)				
	The DPRK	Vietnam	China	Indonesia
Average wage (per month)	7.5 (non-skilled) 100 (skilled)	50 (non-skilled) 120 (skilled)	100-200	60-80(non-skilled) 100-200 (skilled)

Source : SBC (2005)

In addition, other peripheral factors including statutory working hours and insurance in the DPRK were good enough to attract the South Korean businessmen. All in all, the business opportunities in the DPRK with more favorable conditions opened a new horizon for the South Korean SMEs that had been experiencing a deteriorated business climate in overseas production outposts such as China and Vietnam.

The South Korean businessmen, in addition to the immediate profits, considered a far-sighted goal in pursuing inter-Korean business. They tended to view inter-Korean trade as an efficient tool to realize what they called the '*sangsaeng*' economy between the two Koreas. Kim Yong Gu, the president of the KFSMB, asserted that inter-Korean economic cooperation was a pathway toward the inter-Korean '*sangsaeng*' (Kim Y.G. 2003, 114-18). The term '*sangsaeng*' (相生) implied harmonized coexistence and communication based on a symbiotic structure. However, given the term derived from Daodejing (道德經), a scripture on the key philosophical principle of the Chinese

cosmogony elaborated by Laozi, the founder of Daoism (Kohn 2000), '*sangsaeng*' had been understood to include more profound connotations. The word '*sangsaeng*' in South Korean society had been spread to the rank and file as well as political leaders, meaning more than merely peaceful and static coexistence or symbiosis. It rather indicated more dynamic and developing structure or system of morality through which South and North Korean economy could seek to develop economic co-prosperity and political reconciliation in the future. The emphasis on '*sangsaeng*' by the South Korean business community meant that their concerns went further than short-term economic gains such as industrial restructuring and market expansion. Economic gain through individual trade and investment projects was not a final goal but a building block to develop the project into a more interdependent, reciprocal and ultimately unified Korean economy. At the same time, the ultimate aim of the '*sangsaeng*' economy had strong parallels in the ideal of the creation of a South-North economic community which the ROK government had openly proclaimed from the 1990s. The South-North economic community was defined as a collaborative and functional framework in which South and North Korea would seek common prosperity without radical change in their respective economic systems (Oh S.R. 2001, 162-64). In this regard, the first step to shape the '*sangsaeng*' based inter-Korean economic relations would be to find and develop a reciprocal industrial structure between the two Koreas.

Secondly, the expectation that North Korean production factor endowments could well be combined with the desperation of South Korean industrial needs provided another explanatory variable in interpreting the shift of production facilities, especially for the POC trade, into the DPRK. As one study that investigated the two Koreas'

industrial comparative advantage over 13 years (1977-1995) concluded, apparel, footwear, and nonferrous metal manufacturing in the North was supposed to particularly suit the South's capital interested in the investment in the North (Joo S.H. and Cho Y.K. 1999). The fact that these industries were likely to be less affected by the underdeveloped North Korean industrial infrastructure offered another attractive point to enable the South Korean SMEs to embark on inter-Korean collaboration from these areas. Whereas heavy industry firms required massive apparatus, equipment, and infrastructure, light commodity manufacture such as apparel and footwear needed them less.

Thirdly, the light industry collaboration, in this regard, between the two Koreas including the POC meant low-risk, mutually beneficial economic cooperation. While the North Korean economy could acquire more advanced manufacturing technology from the South, the SMEs in the South could take advantage of North Korean production as a first-step test market in an attempt to enlarge their business. As the SBC assessed, the skill of the North Korean workforce in the apparel industry showed remarkable capacity for which no more technological assistance was needed (SBC 2006). The existence of a well-trained workforce in particular industries in the DPRK further stimulated the South Korean SMEs that had been seeking overseas production, with minimal initial risk, to choose the nearest neighboring country.

Furthermore, the closed nature of the DPRK economic system provided the SMEs with the favorable business conditions they were seeking. There were many South Korean SMEs that had initiated business in China and Vietnam but were hoping to shift their production facilities back to more competitive industrial complexes in the Korean

Peninsula such as Kaeseong subject to governmental support (Nam S.W. 2007). For those employers who wanted to avoid the sensitive issues like industrial relations and fringe benefits that they had faced in China and Vietnam, business in the DPRK was a good opportunity to divert it. By maintaining a single contact channel through quasi-governmental organizations such as the NECC or the NECF, the SMEs could relieve the burden to deal with the various requirements from individual factories and enterprises in terms of their labor conditions. South Korean businessman Ok Song Sok (2008), who ran a POC-style factory in Pyongyang, stated,

Many South Korean companies hired experienced agents based in China in an effort to smoothly enter into contract with North Koreans and to avoid likely risk and delay in this overall process. In the contract concluding phase, all we needed to do was pay for the POC fee through the agent. We do not care what is going to happen between the agent and North Korean counterparts such as the NECC. Taking welfare and working conditions of the factory workers into account was their business, not ours.

Given the fact that the South Korean SMEs lacked experience and know-how in tackling industrial relations, the underdevelopment of distribution and welfare issues in the DPRK economy enabled them to give undivided attention to how to manufacture goods efficiently in a cost-saving way.

Fourthly, the ROK government pursued a policy, in the bilateral negotiations to conclude a series of Free Trade Agreements (FTAs), of requesting that its FTA partners

allow exports from Kaeseong to be considered as ‘made in Korea’. The ROK government by doing so made every effort to enable these products to receive the preferential status conferred by the FTA. The ROK negotiators mandated by the Roh Moo Hyun administration managed to put such a provision into the free trade agreements with Singapore, the European Free Trade Agreement (EFTA), and the ASEAN. Ensuring the inclusion of Kaeseong products in the FTAs further convinced the majority of export-led SMEs to be active in considering this uncertain place as a new outpost to exploit its overseas export market.

On the other hand, the formula to treat the products made in Kaeseong in the ROK – U.S. FTA negotiations was built on the conflict of more complicated strategic interest between the two parties than the previous FTA deals. The ROK side insisted on its inclusion as a way of ensuring stability on the Korean peninsula and of easing the presumed costs of an eventual Korean reunification. The negotiators in the United States, on the contrary, argued that the DPRK authority did not meet internationally recognized core labor standards in Kaeseong. They pointed out the lack of basic democratic rights such as freedom of assembly and association by the workers in the DPRK. In addition, they harboured a suspicion that the DPRK government had exploited workers in Kaeseong by taking a large share of their monthly wage under the title of social security payment (Kim S.H.2007).<sup>50</sup>

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<sup>50</sup> The workers in the KIC are not hired directly by the South Korean employers. Instead, the North Korean government agency has a right and responsibility to recruit and allocate the workers for employers in the Complex. Thus the wage is also paid to the workers through this agency after deducting the social security payment. For more discussion on the labor standard issues in the Complex from the U.S. perspective, see Schott et al.(2006).

Even though there were thorny issues between Seoul and Washington on whether the FTA would include Kaeseong-produced goods, the two parties did not rule out the possibility of endorsing it when concluding the negotiation in 2007. They reached an agreement to establish the so-called Committee on Outward Processing Zones on the Korean Peninsula for future discussion on this issue. This Committee is supposed to monitor labor standards in the KIC and to establish criteria before they consider Kaeseong-produced goods as FTA items, depending on the progress of the denuclearization of the DPRK (MOFAT 2007). The ROK government by this endeavour envisioned that large production plants in the DPRK would provide not only alternative production sites for South Korean manufacturers but ultimately frontline export outposts for the global market (Cho B.H. 2003, 3). It should be noted that the Roh Moo Hyun administration had an ambition to make the project one of the flagship achievements in inter-Korean relations during his term. The ROK government's special concern and efforts to develop the KIC within the context of its export-led economic policy constitute one of the key initiatives to induce more SMEs to be involved in this complex in North Korea.

These clear advantages - cost-saving, complementary cooperation in factor endowment, risk-averting and export promotion – that the South Korean firms could gain through production on North Korean soil offered a backdrop to further stimulate inter-Korean economic engagement despite the security instability. In other words, when it came to on-site production by South Korean SMEs in North Korea, it could be argued that the government and small business had a strong shared interest. From the perspective of the government, the greater participation of the SMEs in manufacturing

in the North provided an efficient solution by moving production facilities to less risky foreign soil while avoiding the likely danger of industrial hollowing-out in the ROK economy. The Kim Dae Jung and Roh Moo Hyun administrations accepted that the industrial investment and the construction of production facilities and social infrastructure in the North Korean territory would strengthen the South's long-term economic capacity. They at the same time accepted that the greater investment could underpin the stronger potential of the Korean economy in the event that the two Koreas form an interdependent and unified economic community in the future (Kim Y.Y. et al. 2005). Coupled with the SMEs' own needs for more cost-efficient production, this positive response by the ROK government to the investment in the DPRK Korea constituted one of the elements that encouraged the South Korean SMEs to increase their trade volume despite the security threat at the state level.

#### ***7.6 SMEs and inter-Korean trade : pitfalls***

Twenty years' experience of inter-Korean economic cooperation revealed as many pitfalls to be avoided as the benefits that ROK business had enjoyed. Among many pitfalls the South Korean firms had come across, the unpredictable political environment, the discrepancies in business practices, and the difficulty of direct contact between the two parties have been the main obstacles that made the inter-Korean transactions more demanding than domestic businesses.

Firstly, the political climate in the Korean Peninsula has been so volatile that it led to a fragile condition for sustainable businesses with the DPRK on a longer term basis. During the nuclear crisis since the 1990s, the elements that were likely to trigger

military turbulence have all along existed intact. They included not only the likelihood of increasing tension by the North Korean nuclear development program but also intermittent clashes by conventional armed forces of the two Korean militaries. The United Nations resolutions that resulted in economic sanctions against the nuclear DPRK and Pyongyang's subsequent condemnation for the international punitive actions also destabilized the future prospects for the peace building process in the Peninsula. Once inter-Korean relations were embroiled in political turbulence, it was likely that South Korean businesses would be affected realistically and psychologically by the turmoil. Unpredictable and changeable regional politics created obstacles to make South Korean businesses hesitate over launching large-scale investment projects in North Korea.

Secondly, different business practices that have been developed through the different economic system since the respective nation buildings in 1948 created a barrier between the two parties. According to the South Korean SMEs' experiences, most of all, their North Korean counterparts tended to stress fraternalism in dealing with the South Korean investors rather than acknowledging the pursuit of profit as a basic principle of business world. Such an attitude far from the purpose of the South Koreans involved in inter-Korean business led them to request unacceptable concessions from the South in the name of national cooperation. This far-fetched requirement consequently created unexpected stumbling blocks in continuing to carry out the business. In addition, South Koreans believed that North Koreans lacked proper understanding about price mechanisms, delivery deadlines, and complaints procedures on faulty goods (Kim Y.Y. 2005, 46-47). Some South Korean businessmen even faced a situation in which the

North Korean partners claimed their ownership of the production facilities which had been built and managed by the South Koreans even while the facilities were not in full operation. Totally different business practices and the consequent disputes between the South and the North discouraged the South Koreans and made them doubt whether the inter-Korean business could be sustained on a mutually beneficial basis. According to the survey result in 2006, more than half of the companies involved in inter-Korean business turned out to have continued it less than 3 years (SBC 2007, 34-41). The difficulty in establishing a long-term business plan and widespread uncertainty in terms of the continuity of inter-Korean business was an unavoidable outcome of such a discrepancy between the two parties.

Thirdly, face-to-face contact or telecommunication between the South and North Korea was so uneasy compared with other cross-border transactions that it caused great difficulty requiring the intermediary role of a third party. Complicated and time-consuming customs clearance procedures from the South to the North also needed to be improved. Most South Korean entrepreneurs running their business in North Korea insisted that without solving the so-called 3C problems – commuting, communication, and customs clearance – it was not realistic to expect sustainable business with the DPRK (Lee S.K. et al. 2007, 428-29). After long discussions to improve this situation, the South and North authorities reached two remarkable agreements in order to streamline inter-Korean transaction procedures. As a result, the Inter-Korean Economic Cooperation Liaison Office was opened in October 2005 in the KIC and the two Koreas made an agreement on limited improvement of the 3C issues in November 2007. This progress was an attempt to provide both parties with prompt and uncomplicated contact

channels to revitalize their business. However, the improvement measures such as the extension of border-opening times and allowance of internet use was not satisfactory for South Korean businessmen who had been experiencing great inconvenience in the business in North Korea. Moreover, as the commuting of the South Korean managers from and to Kaeseong, a former military outpost, required the North Korean military's consent, it led to more problematic inter-Korean negotiations. The contribution of the Liaison Office was also more limited than expected as the majority of the South Korean businessmen still preferred inter-Korean contact through intermediary agencies or individuals acting in border cities between China and the DPRK. According to the survey by the SBC in 2006, those who made use of the Office in Kaeseong as an inter-Korean business channel (27%) were less than those who used an existing North Korean counterpart such as the NECF (41%) that had been working in China (SBC 2006, 9). Getting in touch with the quasi-govenmental body in the North was not a proper solution to resolve the entangled contact channels. Although the NECC was the only body authorized to issue a certificate of origin and invitation letter for the South Korean partners, it could not fulfil the South's desire to deal directly with the frontline production unit from the outset. This influential body rather increased the administrative cost of the inter-Korean business by charging a 5 % fee for its intermediary role.

Fourthly, poor industrial infrastructure including harbours/docks and transportation systems in the DPRK caused significant delays in material flows impacting on cost competitiveness and profitability. Shipping schedules were often changed as few goods were transported. Unloading was often delayed even in the largest harbour in the DPRK. Inferior road conditions sometimes damaged materials being

delivered before it reached a final destination (Kim Y.Y. 2005, 40-41). Delays in every step of transactions involving the North Korean infrastructure made South Korean investors unable to sufficiently utilize North Korean domestic factor endowments. They generated unexpected additional costs for the South Korean business as a result. Lack of certainty and stability in terms of predictability became the main obstacles to long-term commitment by the South Korean businessmen. At the same time, how to cope with the disadvantageous conditions such as underdeveloped logistics, transportation, and shipping system in the DPRK became a challenge that most new South Korean investors will have to overcome.

### ***7.7 Actors and drivers***

The pace and scale of inter-Korean business from the perspective of the South Korean businessmen was an outcome of the strategic comparison of benefits and risks (pitfalls) explained in sections 7.5 and 7.6. If the potential benefits from the business in the DPRK are expected bigger than the risks, they are willing to take the risks to gain bigger benefits. On the contrary, they will refrain from taking the risks if the latter are likely to outweigh the expected benefits.

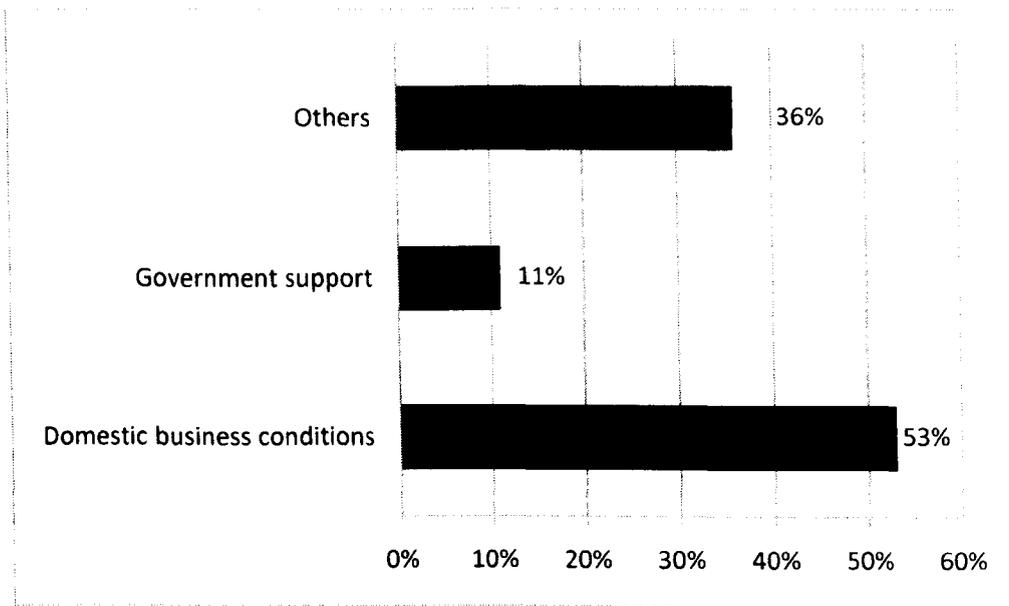
The hypothetical explanations about the increased inter-Korean trade made in chapters 5 and 6, as pull factors, are related to the benefits and potential expectations from trade. On the other hand, the last hypothesis – worsening business conditions in the ROK – is associated with a push factor explaining why the South Korean businessmen took the risks despite many pitfalls they could anticipate.

The push factor-led inter-Korean trade particularly involves new actors and drivers, reflecting growing importance of economic exchanges compared with political dialogues, SMEs compared with *chaebols*, civic level coordination compared with traditional government level contacts. Local governments under the opposition party GNP also played a greater role in economically engaging with North Korean counterparts irrespective of the anti-Sunshine Policy by its central leadership. The survey result also corresponds with these changes.

### *Result of survey*

According to the results of this survey, the most powerful driving force that enabled the South Korean SMEs to consistently pursue inter-Korean trade was found not in the pull factors but in the push factor. Whereas 11% of those who increased or maintained the same inter-Korean trade volume before the crisis chose the South Korean government's support including the IKCF subsidization as a key driver that made inter-Korean trade sustainable, those who took the deteriorating business conditions as the most important factor reached 53%. The majority of the South Korean businessmen who continued the economic engagement with North Korea admitted that they kept engaging with the North in an attempt to secure alternative external production outposts to overcome constantly deteriorating domestic conditions. The government's stimulus package such as the IKCF to promote inter-Korean economic engagement, in contrast, turned out to remain a secondary consideration.

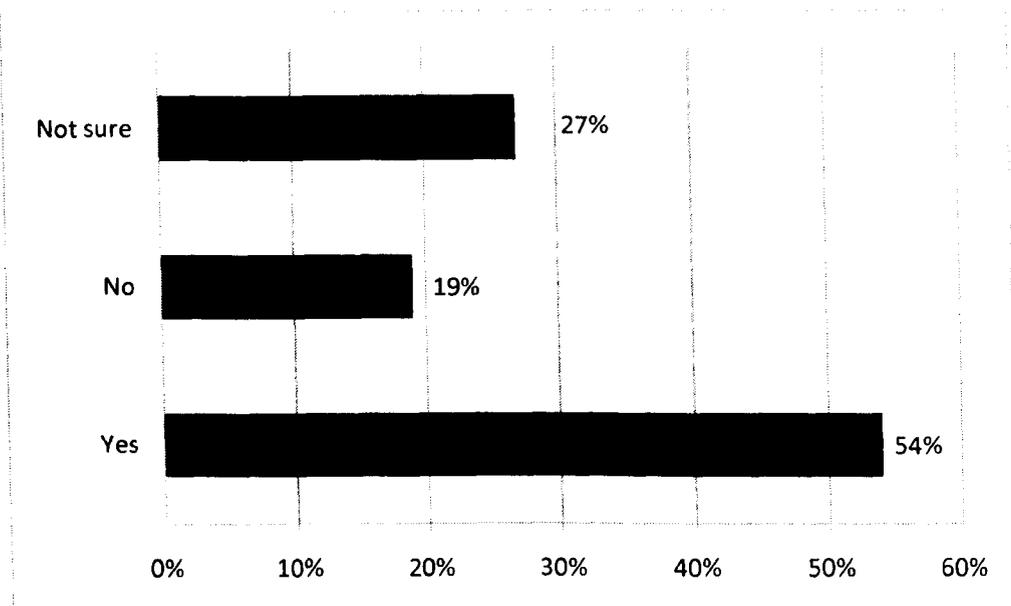
Figure 7.1 What was the most important reason to increase or maintain the trade volume with the DPRK during the nuclear crisis ?



Another type of question to see whether the domestic business conditions affected their decision-making related to inter-Korean trade also showed the significance of the internal factor. 54% of all respondents (including those who decreased the trade volume during the crisis) in the survey said that the domestic production and management environment affected their decision with regard to trade with the North. Only 19.2% answered that it did not. It was salient that a substantial portion of the inter-Korean traders in the South acknowledged that the domestic business conditions, as the primary factor, made them choose business with the DPRK. Those who cited the domestic factors were almost double those who took reform signals in the North and government

intervention in the South as the most important reasons for the engagement. The individual elements that constituted ‘deteriorating’ and ‘unfavorable’ business conditions varied. Among other things, the South Korean businessmen took labor costs as the most significant factor, followed by land and facility costs and powerful labor unions.

Figure 7.2 Did the domestic business environment in the ROK influence your decision making ?



### *Benefits of SMEs*

Reflecting anxiety of the South Korean small business community as to how long their business would remain economically viable in an increasingly disadvantageous environment, the number of companies that embarked on investment in the DPRK continued to grow despite the nuclear crisis from 2002 to 2006. Particularly, South Korean SMEs could enjoy special benefits from inter-Korean trade in this period.

Firstly, the SMEs were less sensitive to the change of political climate and its impact on trade with a politically hostile entity as their business needed fewer political decisions at the central authority level. Prompt and flexible adjustment as the situation changed with respect to their investment decision was more likely for the SMEs than for *chaebols* who essentially required more structural and far-sighted business plans. As one FKI official said in an interview, large conglomerates could not and should not risk political turbulence until the nuclear uncertainty is eliminated simply because their investment risk in the event of failure is too high (*Dong-A Ilbo* 3<sup>rd</sup> September 2004). The political risks the conglomerates have identified came not only from security uncertainty but also from centrally-controlled business system still dominating North Korean economy. As one survey data conducted by the FKI shows, the executives of the large conglomerates pointed out assurances of unfettered business opportunities (26.5%) as the first precondition that needs to be given before getting into the KIC, outnumbering full equipments of a railway/electricity infrastructure (26.3%) and freedom of telecommunication and commuting (20.3%) within the Complex (*Dong-A Ilbo* 16<sup>th</sup> September 2002). The security risks and the unresolved suspicion of danger in launching large scale business in communist economy significantly undermined *chaebols'* high hope on the potential benefit from inter-Korean business.<sup>51</sup> The reluctance of the major economic players in the ROK economy offered the SMEs a bigger space to do inter-Korean business, combined with the government efforts to revive the SMEs-led manufacturing industry.

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<sup>51</sup> Economic gain that South Korean industry can acquire from inter-Korean transactions was measured as double as that of North Korea, according to the research by the FKI, longstanding mouthpiece of Korean *chaebol* (*Hankook Ilbo* 9<sup>th</sup> October 2002).

Secondly, large scale investment projects in the DPRK carried out by the South Korean *chaebols* were less feasible, if not unlikely, given the poor industrial infrastructure in the North and the underdeveloped institutional supports from the South. Samsung Electronics, the world's largest electronics company and a flagship subsidiary of Samsung Group headquartered in Seoul, for example, arrested repeated attention on whether or when the company will launch inter-Korean business in response not only to the ROK government's implicit hope for its participation but to the DPRK government's invitation as Hyundai was facing a liquidity crisis from about 2000. Samsung Electronics has actually been conducting a joint project for a computer software development in collaboration with the Korea (Chosun) Computer Center (KCC), the IT industry arm of the North Korean cabinet. Moreover, a group of executives of Samsung Electronics has visited Pyongyang and discussed industrial cooperation issues with the NECF officials (*Hankook Kyongje* 26<sup>th</sup> March 2003). But whenever the wide speculation of its joining inter-Korean business is spread, the multinational company, of which more than half of its shares were owned by foreign investors, denied the possibility by pointing out the foreign shareholders' concern about Samsung's investment decision in such a highly volatile region, along with the potential risks coming from underdeveloped basic infrastructure as main stumbling blocks. As a result, South Korean *chaebols*, with an exception like a few subsidiaries of Hyundai Group, were largely reluctant to pursue a joint project with North Korean counterparts. On the other hand, SMEs looking for alternative production base could gain promising opportunities in the North to make use of low-wage, well-trained labor force with less risk than *chaebols*.

Thirdly, *chaebols* tend to be more likely to be interested in strategically exploiting a new consumer market and large enough export revenue based on their own advanced technology. Samsung Electronics' abortive preliminary plan to build an assembling plant in the KIC was an example to show how the large manufacturer's strategic business goal was not met in the context of North Korea. In contrast, the purpose of the South Korean SMEs in pursuing business in North Korea was relatively simple. As long as the North Korean labor force gave them more cost-effective means of production, indigenous economic conditions in the socialist economy did not have a great influence on their decision to go to the DPRK for more profitable business (Dong M.H.2002, 39-42).

What was striking was not only the growing number of investors during this period but also the expansion of the business areas involved. From about 2006, joint computer software program development projects, animation and other digital contents production projects became one of the most promising areas that could benefit from inter-Korean cooperation. The initial investment budget needed to embark on a joint software development project was not as costly as that of manufacturing industry that needed a full set of production facilities. This feature of IT industry constituted a good starting point for South Korean SMEs to launch their business in the DPRK without taking great risks of investment failure (MOU 2007, 44-47).

### *Growth of the KIC*

On the other hand, the constant growth of the KIC during the nuclear crisis showed that the driving force of inter-Korean economic cooperation was not undermined by the crisis despite deteriorating security instability. The driver that enabled the KIC to overcome the political obstacles from the crisis came not only from the political steadfastness of the Kim Dae Jung and Roh Moo Hyun to push forward inter-Korean reconciliation initiative but from, more importantly, South Korean economy's own needs for domestic industrial development.

Since the ROK government embarked on ground-breaking work of the KIC site in 2003, the 3.3 million m<sup>2</sup> joint industrial complex continued to show stable subsequent development in the following years. The first-ever product in the Complex began to be sold in the domestic and international market from 2004. The KT (Formerly known as Korea Telecom) and Korea Electric Power Corporation (KEPCO), quasi-governmental industrial organizations in the ROK, began to transmit in 2005 electric power and to install direct telephone lines to the Complex in the DPRK for the first time since the end of the Korean War in 1953. Overcoming the chronic shortage of electric power and unaffordable cost of telephone bills that had previously used satellite systems via Japan enhanced the possibility of success of this joint production experiment by considerably reducing the transaction costs that South Korean investors had to pay. At the same time, the South and North Korean authorities made joint efforts to streamline the entry procedure of South Koreans involved into the North Korean territory, customs clearance, and quarantine regulations in an attempt to eliminate institutional barriers in operating the KIC.

All the progress has been made since the security in the Korean Peninsula had been engulfed in the mounting crisis caused by the North Korean revelation of its nuclear program in 2002. The improvement of the industrial infrastructure for an enhanced production environment was mainly aimed at resolving, to the satisfaction of South Korean businessmen, the practical inconvenience that has been raised by the managers of individual companies since the opening of the KIC. The uninterrupted development of the inter-Korean economic projects during the nuclear crisis showed observers of the Korean Peninsula the evolving significance of economic interplay in the political relations between the two Koreas. The role of the economic transactions between the two Koreas was developing from a mere dependent variable heavily affected by the high politics in and around the Korean Peninsula into one of the defining factors shaping inter-Korean relations even during the political crisis.

On the other hand, the growing significance of economic exchanges in inter-Korean relations was also acknowledged by the North Korean leadership. The capital investment made by the South in the North territory was proved by Kim Jong Il's remark as a welcome move irrespective of the generally anticipated likelihood of political reliance, caused by the capital influx into the isolated system, upon external power.<sup>52</sup> The 'Kim Dae Jung Memoir' (2010), published after his death, unveiled Kim Jong Il's thought on the relationship between politics and economy in managing inter-Korean relations, by introducing a part of Kim Jong Il's remarks in the summit talks.

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<sup>52</sup> On the broad literature review of the dependence relationship in international relations and its negative ramification in a weak state's foreign policy, see Baldwin (1980), pp. 492-495.

I would have disagreed with the idea of inter-Korean summit if your visit to Pyongyang had driven by the NIS as I have unfavourable impression on the Korean spy agencies in the past. In contrast, the smooth progress of the inter-Korean economic projects at the civic level jointly developed by the CAPPK and Hyundai convinced me to have a summit talks with the South. (Kim D.J. 2010, 277)

Kim Dae Jung previously anticipated that his '*Jongkyong Bulli*' policy will in the end bring about attitude change of North Korea in dealing with inter-Korean economic affairs. He wrote in his memoir after Chung Ju Yung, the president of Hyundai Group, had a unprecedented direct meeting with North Korean supreme leader Kim Jong Il..

It was a meaningful change that Kim Jong Il began to be directly involved in inter-Korean business. I reckon that North Korea responded to our repeated door-knocking by opening it at last. I think there were some changes in the North Korean system after Kim Jong il took office as a Chairman of the National Defence Commission. My guess was that the pragmatic group within the leadership began to raise their voice. I suspect that my government's consistent pursuit of 'civic level economic cooperation first, inter-authority dialogues later' policy successfully made North Korea move towards internal change. As a result, I expected to have an opportunity to meet up with North Korean leader Kim Jong Il within my term. (Kim D.J.2010, 125)

The economic exchange projects driven by private firms and pioneering entrepreneurs also became a key driver for the successful growth of the KIC. In this sense, the South Korean government's industrial policy and North Korea policy constituted both sides of a coin. The South government's economic policy to allow the business community to engage with North Korea with their own domestic agenda enabled the SMEs to pursue the continuity of inter-Korean business amid the mounting nuclear crisis.

#### *Local governments*

The significance of domestic needs of the South Korean SMEs in pursuing economic cooperation with the potentially nuclear power also signalled a couple of transformations in terms of the drivers and actors of the economic engagement strategy. The ROK government's initiative to promote inter-Korean economic engagement has been developed with close links to the domestic economic policy in order to find a way out of the economic impasse the South Korean SMEs had faced. Even before the proclamation of the 'Sunshine Policy', the Kim Young Sam administration made it clear in 1994 that his government would give priority to SMEs pursuing inter-Korean economic projects. As part of the SMEs-first policy in inter-Korean business, Kim Young Sam opened ten professional consultation centers across the nation in an attempt to assist the SMEs that showed interest in it but were unable to launch the business without any external help. KITA, the South Korean private organization for trade

promotion, provided a venue and professional advisors for the consultation (MOU 1995, 258-263).<sup>53</sup>

The active involvement, in pursuit of inter-Korean economic transactions under the Kim Dae Jung and Roh Moo Hyun administrations, by a group of local governments dominated by the opposition party demonstrated the priority of a similar ‘domestic economy first’ policy. For example, since the local elections in 2002 in the ROK, Incheon Metropolitan City and Gyeonggi Province, the very southern regions of the DMZ, were under the control of the Grand National Party (GNP), which strongly condemned the ‘Sunshine Policy’ labelling the Kim Dae Jung and Roh Moo Hyun era as a ‘lost decade’. The two local governments however vigorously pushed forward their own economic projects that required close collaboration with the relevant organizations in the DPRK (Choi Y.H. 2006, 28-41).

The Mayor of Incheon, while maintaining the key position in the GNP’s local government leaders line-up, became the first-ever governor who visited Pyongyang and made broad agreement on a range of joint socioeconomic projects. His visit was made in May 2005, while the North Korean state media has been vehemently condemning the GNP’s foreign policy line labelling it a warmonger and fascist conspirator. Incheon city government’s joint projects in this mood with the North Korean counterparts included its bid to co-host the 2014 Asian Game with Pyongyang and many other civic level economic exchange programs.<sup>54</sup> The Mayor was accompanied in the Pyongyang visit by

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<sup>53</sup> Unlike the administration’s plan, the majority players of inter-Korean economic engagement as of 1999 were filled up by non-SMEs (Cho B.H. 2003,4).

<sup>54</sup> The co-hosting bid failed to achieve a wider consensus within the Olympic Council of Asia (OCA) and Incheon alone ended up successfully winning the bid in December 2006. But it was not because of the lack of endeavor by the City but because of the likely legal row in the Committee on the co-hosting issues (*Seoul Shinmun* 26<sup>th</sup> September 2006)

a delegation from local business council and civic organizations to deal with above all different economic cooperative projects. Welcoming this bold approach from the GNP-dominated local government, the North Korean counterparts, National Reconciliation Council (NRC), nominally representing North Korean political parties and social organizations, gave the delegation an exceptional permission to use non-diverted direct flight route between the South and the North and sent out passenger jet to transport them back.

Gyeonggi Province, which surrounds Seoul and Incheon and shares the northern part of its area with North Korea, also served as the main channel for inter-Korean economic exchanges. Gyeonggi Provincial government has also been dominated by the GNP since 2002 local election. But Gyeonggi was so active in pursuing inter-Korean economic exchanges that has been running a rice farm as a pilot project in the vicinity of Pyongyang in collaboration with the North Korean agricultural authority. Based on the achievement of the pilot stage project, the deputy governor-led delegation visited Pyongyang in 2006 to take part in signing event of the agricultural modernization project. This visit was made amid the hesitant mood for the central government to enforce the scheduled visit of the Unification Minister to Pyongyang as a result of the military tension created by the U.S.-ROK joint military drill in that particular period. Sohn Hak-kyu, the Gyeonggi governor stated in an interview.

What is actually important is not to merely offer a humanitarian aid or one-off economic support program alone but to carry out consistent inter-Korean cooperative projects through which North Korea can consolidate its

economic foundation and the both Koreas achieve co-prosperity. The key tenet of what I would like to label 'peace management policy' in this regard is strengthening constant inter-Korean economic cooperation from the perspective to accomplish 'the Korean Peninsula economy' in the global context. I would not save our provincial budget in pursuing inter-Korean economic exchanges, cooperation, and peace-building (*Naeil Shinmun* 6<sup>th</sup> October 2005).

As a governor who has been championing the foreign direct investment for a provincial government, his commitment to inter-Korean cooperation was also built upon his emphasis on economic need to exploit North Korean resources in order to boost domestic economy of his own constituency.

The undiluted support for economic cooperation between Gyeonggi and its Northern counterparts was inherited by Sohn's successor Kim Mun-Soo from the GNP, a passionate North Korean human rights campaigner who had dramatically departed from his early career of the socialist trade union movement leader. Kim has been requiring his Party an uncompromising posture on the human rights violation of the North Korean regime but at the same time he firmly advocated economic exchanges with North Korea and continued to put forward various cooperation agenda. It included the initiative of the DMZ Eco-peace Park and the joint investigation project for flood prevention of the Han River, passing through North Korean territory and Gyeonggi alike. He further stressed the role of Gyeonggi in economic cooperation with its Northern neighbor by asserting that the Province has potential credential to carry out the role of

‘special envoy’ to break up the stalemate in inter-Korean broader economic cooperation apart from Kaeseong Project under the Lee Myung-bak administration (*Kyeongin Ilbo* 30<sup>th</sup> October 2008).

Other provincial governments dominated by the GNP were of no exception, although it was not as likely as Gyeonggi and Incheon to discover feasible and commercially viable cooperation projects with the North. For example, Gangwon, the eastern coastal province, of which its territory was divided into South and North as a result of the Korean War, put forward a couple of inter-Korean economic agenda even though the anti-North Korea sentiment still prevailed in people’s memory, derived from their experience of brutal killing occurred during the War less than half-century ago. The Gangwon Provincial government, from the perspective of its domestic economy, was recognizing the rivalry relationship with outpaced Gyeonggi in building up a cooperative relationship with its neighboring economy (*Gangwon domin Ilbo* 15<sup>th</sup> August 2007).

Pusan Metropolitan City and North Kyungsang Province, a long-time stronghold of the conservative GNP, also tried to find opportunities to be involved in inter-Korean business. Pusan, the biggest harbor city in South Korea, showed interest in boosting its shipbuilding industry in connection with North Korean workforces and resources. North Kyungsang that has heavily populated eastern coastal cities wanted to develop a cruise travel package along the coastal line in cooperation with North Korean coastal cities, along with many other projects likely to support its local business including herbal medicine or fishery product processing (*Sekye Ilbo* 8<sup>th</sup> October 2007).

The leaders of Incheon Metropolitan City and Gyeonggi, Gangwon Provincial governments took great advantage of the geographical proximity to North Korea despite the political creed of the party they belonged to, which proclaimed it would reverse the course of actions by the Kim Dae Jung administration. The vast majority of the economic cooperation projects with the North initiated by these local governments were planned to meet the needs of the local SMEs. Other GNP-led local governments' exploratory plans for inter-Korean business were also driven by their industrial demands. Furthermore, the GNP central leadership, who has coherently been unsympathetic to the economic appeasement toward the DPRK, did not object to these deviations from the party line. This suggested that the need to find an alternative business partner under dire economic climate for local SMEs became a top priority at all levels of public administration transcending party lines. At the same time, the local governments' economic engagement with the DPRK provides visible examples to explain how the benefits from the economic exchanges are likely to supersede security-dominated political dynamic in the Korean Peninsula.

#### *Transnational level coordination*

The role of the South Korean non-governmental and business organizations became crucial in determining, by negotiation, the pattern and pace of inter-Korean economic projects. From the South Korean business's point of view, two dimensions should be noted to understand this subnational level cooperation between the two Koreas. The detailed agreements that actually drove inter-Korean trade were discussed

and concluded through these channels. One is located in the context of inter-Korean interactions and the other is in the domestic economic management in the ROK.

The creation of the NECC in 2004, as a North Korean key institution to promote inter-Korean trade, made a remarkable contribution to forming a fast-track channel between traders. The NECC activities signalled the North Korean desire to more actively pursue economic engagement with South Korea and subsequently offered a new institutional model to reinvigorate inter-Korean trade. With more than doubled staff and an enhanced political power, the NECC showed an ability to stem the growing discontent of the North Korean military toward the expansion of the inter-Korean engagement (Lee K.S. 2005). The partial devolution of the leadership in inter-Korean relations to the NECC implied the negotiation channel was being pluralized as Pyongyang looked forward to gaining more from economic engagement with Seoul. A statement by a South Korean businessman showed the growing power of the NECC in trade with the ROK.

When I first proposed that inter-Korean trade goods needed to be transported by land route from Kaeseong to Pyongyang to the NECC, they were unwilling to accept it as it required an additional approval from the North Korean military to make it happen. But later they managed to elicit agreement from the military, which demonstrated their political power within the North Korean authority (Lee K.S. 2005).

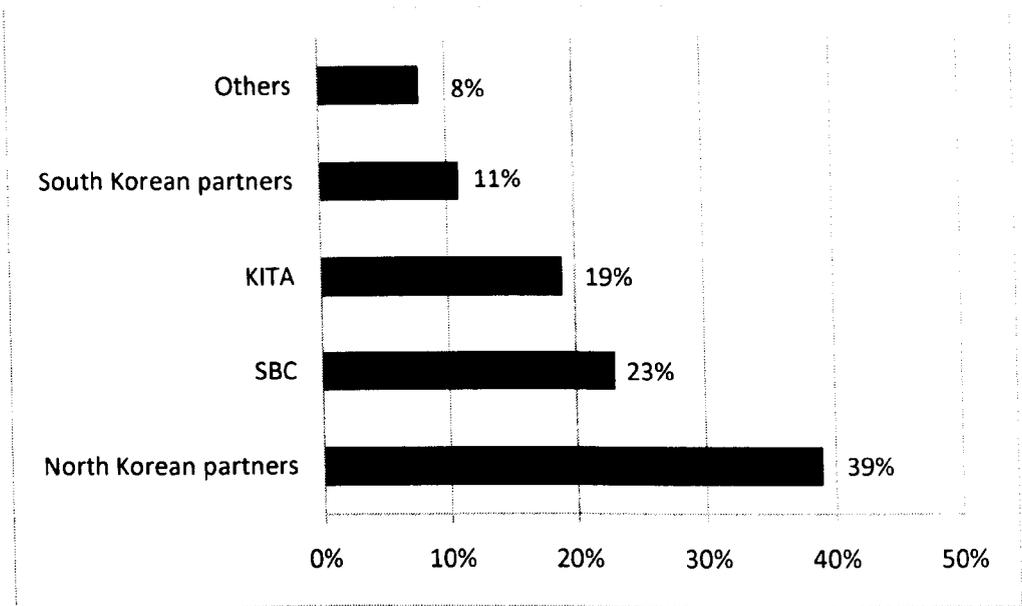
Another South Korean businessman Ok Song Sok (2008), who moved his production base from China to North Korea after 2001, confirmed that the NECC officials had close networks with high-ranking figures in the power group in Pyongyang. According to his experience, the demands from South Korean investors such as prompt supplement of factory workers through the NECC channel was accepted quicker than they had expected. Contractual obligations to meet agreed delivery dates were quite often disregarded in the practice of trade with the DPRK but if an ultimatum was delivered through the NECC, the production progress was visibly improved.

The growing influence of North Korean subnational organization in inter-Korean trade was also reflected in the survey results. South Korean businessmen answered in the survey (Figure 7.3) that a greater contribution to the inter-Korean trade after 2002 came from North Korean counterparts like the NECC (39%) rather than domestic consulting organizations such as KITA (19%) or the SBC (8%). This also suggested the partnership between actors outside official diplomatic negotiation under complex interdependence had been consolidated.

But the DPRK Supreme People's Assembly reportedly abolished the NECC in April 2009. The relevant roles were reallocated within the central authority but many of them were transformed and moved from the Cabinet into subunits of the Party. This decision confirmed widespread rumors of a kickback scandal and the impropriety of US dollar transactions between NECC frontline officials and South Korean businessmen (*Dong-A Ilbo* 10<sup>th</sup> April 2009). South Korean businessman Ok Song Sok (2008) too said that there was a rumor of a corruption scandal connected to a very competent NECC official in which the North Korean central authority uncovered a massive amount of

hoarded US dollars in his house. In the ROK business community, the abolition of the NECC was interpreted as a sign showing North Korean determination to crack down on the spread of liberal economic ideology from South Korea amid the increasing inter-Korean exchanges. At the same time, this showed paradoxical evidence that the period from 2002 to 2006 could be interpreted as a golden age when it came to inter-Korean trade involving subnational actors in the two Koreas.

Figure 7.3 What was the key organization apart from the ROK government that affected your trade with the DPRK positively?



The other dimension that contributed to promoting South Korean business community’s engagement with the North came from many civic organizations that had been established on the ROK side. These organizations were created for the purpose of directly and indirectly supporting inter-Korean economic engagement in an attempt, at least in part, to make a breakthrough for the struggling SMEs. The organizations would drive forward non-political, civic level exchanges between the two Koreas on the one

hand, dampen or internalize the opposition voice from conservative groups in South Korean society on the other.

The Korean Council for Reconciliation and Cooperation (KCRC) established in 1998, for example, offered a venue in which contending political voices, respectively representing the conservative and the progressive groups in South Korean politics and NGOs, could make efforts to fill the gap between them. There was no evidence that the conservative group fully endorsed what they called the appeasement policy toward Pyongyang by participating in bipartisan organizations such as the KCRC. But it was evident that the Council led intra-Korean dialogues on the controversial North Korea policy which had been inconceivable under the previous regime as well as organizing many social and cultural events with its North Korean counterparts. In particular, the South Korean presidents displayed their special interest in this bipartisan organization by appointing a heavy-weight figure from their top aid group members as chairman of the KCRC <sup>55</sup>.

Other organizations built purely as NGO-style political campaigns emerged to drum up support for the then government's actions. The Civil-headquarters for Activating South-North Economic Cooperation in Korea (CASNEC) established in 2003 aimed to indirectly support the government's plan for inter-Korean economic engagements by hosting a variety of academic conferences and cultural events on similar issues. The Solidarity for Practice of the South-North Joint Declaration (SPJD) further contributed to radical reformation of the conventional discourse in South Korean

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<sup>55</sup> For example, the standing chairman of the KCRC in the Kim Dae Jung administration, Han Kwang Ok was a former chief secretary of the presidential office and Cheong Se Hyun, standing chairman in the Roh Moo Hyun government was a former minister of MOU.

society in viewing North Korea. These two examples showed South Korean civil society's involvement in forming a political discourse on the DPRK which had previously been monopolized by the government.

There had long been quasi-governmental organizations such as the National Unification Advisory Council (NUAC) since the 1980s, established in an effort to mobilize nationwide support and consensus for the unification policy by the then government that had lacked public legitimacy. The NUAC based on the ROK constitution was largely funded by the government and boasted an overseas network in 31 nations as well as a local network across the ROK. The Council made contributions in the 1980s-90s to trumpeting the key announcements by the ROK government on its unification agenda but had connections neither with North Korea nor with civic society in South Korea. Unlike the NUAC, however, the newly-emerging civic organizations built on grass-roots support for the engagement policy by the ROK government showed a new possibility that the multiple channels of contact between the two Koreas could connect both societies in a broader area. The emergence of new contact channels in the bilateral negotiation constituted one of the key features of transnational level coordination and in turn complex interdependence that framed inter-Korean relations after 2000.

## ***7.8 Conclusion***

Even though cross-border production and distribution constituted one of the most significant agendas in the realm of IPE, they were largely focused on global networks of global firms. The desperation of small businesses that struggled in their domestic market

due to rising production costs was not sufficiently explored in the mainstream IPE. Division of labor at a regional – not a global – level could be an alternative recipe in the first place to overcome the handicap of domestic production. The most preferred area for the South Korean manufacturers to relocate their production facilities used to be the eastern fringe of China, within an hour's journey by plane from the Western coastal cities of the ROK. However, as the wage conditions and the government regulations got tougher, the less competitive South Koreans faced the necessity to find alternative production bases. Although occasional economic exchange programs had continued since the 1990s, launching a large scale cooperative project in North Korea required the resolution of the nuclear crisis first to ensure the continuity of the business. The common goal of the South Korean government and the SMEs was how to maximize the gain of economic engagement with North Korea and at the same time how to minimize the potential risk to inter-Korean business.

This chapter investigated a key factor for the South Korean SMEs in the manufacturing industry to increase their trade volume with North Korea from 2002 to 2006. The chapter concluded, based on the survey results, that they were forced to choose economic engagement with North Korea due mainly to rising production costs in the domestic market. The ROK government policy to financially and institutionally support inter-Korean trade on the other hand brought about a positive effect in attracting more attention to the economic engagement even though there was a growing tension in the Korean Peninsula. However, a more crucial driving force came from the commercial judgement by entrepreneurs to reduce their production costs according to the survey.

The combination of the private interests of business community on the one hand and a government initiative to promote inter-Korean trade on the other became an engine to expand economic relations between the two Koreas. The state's role in this mechanism was rather supportive and secondary in this market-driven economy. Domestic trade interests had a strong voice that was able to prevent an escalation of tension into real conflict.

One of the key findings in this regard was how the ROK government made a contribution to the invigoration of inter-Korean trade. The substantial role of the government did not come from its direct intervention such as preferential finance but came from its 'parallel-track' strategy that equally valued political and economic relations typified by the '*Jongkyong Bulli*'. The '*Jongkyong Bulli*' policy by the Kim Dae Jung administration permitted the business actors in the South to engage with the North as long as it was commercially justifiable and viable. The policy made it possible by ensuring the disconnection of the tight linkage between the economic engagement and the nuclear issues maintained in the previous administrations.

Additionally this chapter examined the changed route of mutual engagement between subnational actors in the two Koreas. The result of the examination showed that a new channel between the two Koreas emerged to exclusively deal with economic projects. Pyongyang condoned the quasi-governemental organizations such as the NECC to exercise relative autonomy in planning and implementing the cooperative projects despite objections from the military. Such a diversification of inter-Korean contact channels also contributed to cementing inter-Korean economic engagement until Pyongyang decided to withdraw the political power the NECC had enjoyed.

All in all, the standing of the South Korean SMEs has consistently been undermined in the domestic market since the late 1980s. The ROK government and business community took advantage of this opportunity to engage more with the DPRK in an attempt to strengthen peaceful coexistence between the two countries. The '*Jongkyong Bulli*' policy by the South government and the broadened contact channels between the South and the North made the economic engagement more sustainable despite the growing military tension in the Korean Peninsula.

## CHAPTER 8

### Conclusion

#### *8.1 Introduction*

This chapter will suggest final concluding points by revisiting the key findings and arguments made in the earlier chapters. It is organized into six parts. The first section will briefly summarize the findings of the earlier chapters, focusing on the casual relationship between the nuclear crisis and inter-Korean trade. The second section will re-summarize the contribution of this study to a broader knowledge on inter-Korean relations into three points. The third section will attempt to apply these findings to an interpretation of broader inter-Korean relations during the nuclear crisis. The section will show that the economic relationship between the ROK and the DPRK since 2000 was not necessarily subordinated to progress in political relationships between the two parties. It will also argue that the economic variable is increasingly significant in interpreting the goals of the DPRK's nuclear development. The fourth section will re-examine the complex interdependence model as the main theoretical framework of this thesis and stress what needs to be refined to better explain the case of inter-Korean economic and other patterns of relationship. The fifth section will propose a set of policy prescriptions from the viewpoint of the ROK government in dealing with economic relations with the DPRK together with its nuclear program. The sixth section will provide a brief recommendation as to how to utilize the achievement of this study in developing ROK and/or DPRK related research in the future.

## 8.2 Summary of findings

This study has attempted to identify whether and to what extent the nuclear crisis that erupted in 2002 in the Korean Peninsula affected the trade relationship between the ROK and the DPRK. For this purpose, it examined the flow and changed pattern of inter-Korean trade from 2002 to 2006. After 2006, the DPRK regime began to crack down *de facto* liberal economic activities resulting in partial closedown of exchange avenues between South and North Korea at the subnational level. In the ROK, on the other hand, the conservative government that came into power in 2007 introduced a stricter guideline in allowing the South Korean economic actors to engage with the North. Based on such a sharp contrast before and after 2006 since the outbreak of the second nuclear crisis, this study concluded that this five years period (2002-2006), although the nuclear crisis constantly heightened in this period, created a golden age when it came to inter-Korean economic transactions.

An equally important purpose of this study was to explore the main causal variables that drove South Korean entrepreneurs to conduct business with allegedly 'nuclear' North Korea during the crisis between 2002 and 2006. For this purpose, this study tested three hypothetical claims such as the financial incentive program offered by the ROK government, economic reform package introduced by the then DPRK leadership, and the domestic industrial factors in the ROK. Based on such a structure of this study, the key findings so far can be summarized as below.

Firstly, as shown in the inter-Korean trade statistics and the results of the survey of South Korean SME businessmen, the second nuclear crisis did not predominantly affect the practice and conditions of the ROK's trade and investment with the DPRK. The

traditional assumption that trade and other forms of economic exchanges could be drastically reduced, if not stopped, under the condition of mounting military tension can be challenged by this finding. Non-commercial trade such as the humanitarian aid program turned out to be affected by the nuclear crisis as it saw little progress especially in 2006 in the wake of the North Korean nuclear test. But as commercial trade continued to grow during the crisis, it developed into a major pattern of inter-Korean economic exchanges. The joint manufacturing projects in Kaeseong grew dramatically in the same year that the nuclear crisis reached a peak. All these moves provided evidence showing little causal relationship between the military crisis and commercial interactions between the two Koreas.

It is true that South Korean entrepreneurs perceived the nuclear crisis as a serious 'risk' which was a significant blow to their business with the DPRK. But there was no clear evidence that they took the crisis as a real 'threat' to destroy their achievement. They rather accepted it as a controllable and manageable 'risk' as long as the ROK government's supportive attitudes continued. The earlier chapters show that the fundamental change in the inter-Korean relationship provided a background variable that prevented the risk from developing into an uncontrollable threat.

Secondly, in terms of which factor primarily affected the South Korean business community's behavioural pattern in inter-Korean trade, this study showed that domestic factors in ROK industry played a crucial role. In contrast, the institutional changes toward economic liberalization and decentralization within the DPRK regime had little influence on the South Korean business community's decisions related to trade and investment in the DPRK. It was likely that the South Korean SMEs expected to see

North Korean economic entities as potentially more viable partners than China or Vietnam. But what this study showed is the SMEs in the South were less receptive to the external factors, which they perceived as only a secondary influential factor, than to domestic factors such as their own labor costs and taxation.

The South Korean SMEs faced great difficulties in sourcing enough low wage workers to meet their production targets from the late 1980s. Low-wage based business strategy became less viable due mainly to the organized labor unions movements in the wake of the democratic transition embarked in 1987. As the wage offers from the SMEs did not satisfy employees' expectations, employers faced a chronic shortage of workers particularly in low-wage based traditional manufacturing industries. The SMEs were in a vulnerable predicament in comparison with the *chaebol* that had enjoyed strong government backing as the most powerful growth engine of national economy. A vast majority of low-wage based manufacturing industries shifted their production facilities to China and Vietnam to seek lower labor and land costs. But they began to feel higher pressure stemming from increasing labor cost and tougher government regulation from about 2000. The deteriorating business environment surrounding the South Korean manufacturers in danger provided a primary cause for them to choose the DPRK as an alternative production site or trade partner. The ROK governments in power from 1998 to 2007 encouraged them to engage more with their Northern partners by putting a set of deregulation measures in place for the purpose of making inter-Korean non-political exchanges easy. The governments had the aim to make the accomplishment of inter-Korean reconciliation and cooperation one of the flagship achievements in its foreign policy.

This finding challenged traditional beliefs on the history of inter-Korean relations. The traditional view was based on the thinking that the North tended to engage with the South to seek economic support whereas the South did so with the purpose of political and humanitarian objectives (Noland 2000, 112, Burghart 2009). However, this study showed that the economic needs of the ROK began to constitute a more significant motivation to engage with the DPRK. The South Korean SMEs, as key actors in inter-Korean trade since the 1990s, that had sought a more competitive production environment played a critical role in creating such needs. The then ROK government also made every effort to push forward the inter-Korean economic cooperation strategy as one of the key axes of its functionalist approach toward the DPRK.

Thirdly, inter-Korean relations after the inter-Korean summit in 2000 showed comprehensive and encouraging changes which subsequently led inter-Korean trade to continue to grow despite the second nuclear crisis from 2002. These changes ranged from the emerging mood of political reconciliation to the rapidly growing socio-cultural and economic exchanges as a result of a set of agreements between Kim Dae Jung and Kim Jong Il. The most salient feature among these changes was the increasingly important role of non-state actors such as civic organizations and business in planning and implementing exchange programs with the counterparts in the DPRK. Instead of having a monopolistic and exclusive diplomatic power, the ROK government permitted South Korean subnational actors to engage with North Korean entities based upon their own plans and timeframe.

As the survey results showed, the South Korean business community also acknowledged the substantial expansion of inter-Korean dialogue channels. Direct

contacts between South Korean firms and their counterparts in the North, without recourse to the government's leading role, became a dominant way to discuss and determine the conditions of inter-Korean economic transactions. The establishment of quasi-governmental organizations in the DPRK such as the NECC with the purpose of expanding economic cooperation with the South gave South Korean businessmen an opportunity to streamline their trade procedures with the North. The NECC allegedly enjoyed relative autonomy in dealing with ROK counterparts, in comparison with many other government agencies, to implement the agreed cooperation projects.

The dramatically increased number of trading companies in the North that had their own target to meet in earning foreign currency was another factor to explain multiple channel economic contacts between the two Koreas. The 'new trade regime' introduced in the early 1990s also involved a new initiative which allowed local governments, provinces, and a variety of governing committees within the Cabinet alike to run their own trading companies. As a ramification of this decentralization in trade management, from the North Korean point of view, inter-Korean trade became one of the sought-after routes to earn foreign currency resulting in diversifying contact channels between the two Koreas.

Such a widened inter-Korean contact channel also contributed to cement inter-Korean economic engagement until Pyongyang reportedly decided to withdraw economic power from the frontline organizations in about 2006 fearing likely ideological contamination from the capitalist economic transactions with Seoul. This changed environment and high expectations for further development of inter-Korean

trade enabled South Korean business actors to maintain their trade volume and pattern despite the uncertain prospects for the continuity of inter-Korean trade.

Fourthly, the complex interdependence model proposed by Keohane and Nye (1989) provides the most useful explanatory model to analyze the substantial changes of inter-Korean relations after 2000. The complex interdependence model is characterized by three key features : multiple channels, lack of issue hierarchy, decreasing role of the military. The essence of extensive changes in inter-Korean relations triggered by a set of agreements from the inter-Korean summit demonstrates a great deal of affinity with the complex interdependence model. The Kim Dae Jung (1998-2002) and Roh Moo Hyun (2003-2007) administrations put great efforts into forging economic and cultural ties between the two Koreas even while the nuclear crisis showed no sign of coming to an end. This policy change dramatically broadened the horizons of inter-Korean direct dialogue at the sub-national level. As the two Korean governments in this period agreed to seek ways to ease military tension and to avoid unexpected conflict by miscalculation, the use of military force as a means to resolve inter-Korean conflicts became less likely.

### ***8.3 Contribution to knowledge in inter-Korean relations studies***

Firstly, this study offered a new analytical tool to overcome security biased interpretation of inter-Korean relations. The dominant studies on the DPRK and inter-Korean relations suggest that a new proper viewpoint needs to be arranged to capture the essence of the growing economic exchanges between the two Koreas after the 1990s. Particularly, a variety of economic cooperation projects that had persisted during the

second nuclear crisis required a new perspective to understand security assurance and economic interest in an interconnected fashion. This study demonstrated that the security variable in the Korean Peninsula was no longer a unitary factor shaping and transforming inter-Korean relations. Economic interest based on domestic industrial needs instead emerged as a more influential causal variable in bringing sustainable inter-Korean reconciliation. Dramatic increase of multi-level interactions between the two Koreas after 2000 enabled South Korean SMEs to continue to carry out economic transaction with the North even though the security situation was significantly destabilized. This study offered an alternative perspective to explore the security dynamics in the Korean Peninsula by focusing on the importance of economic interest of state and non-state actors and by showing under which conditions economic issues could rise to the surface.

Secondly, the conclusion of this study showed that domestic economic policy needed to be equally considered, along with international security concern, as an analytical starting point to explore inter-Korean economic cooperation. The vast majority of studies on inter-Korean economic exchanges in reality have been focusing on the impact and ramification of the economic interactions between South and North Korea. This meant that the primary focus of research was the influence of economic exchanges on whether it was likely to contribute to peace building or not. In IR studies on the Korean Peninsula situation, political reconciliation and security building have always been the priority even when tackling economic exchanges in a burgeoning stage. As a result, most economic activities by the South which were likely to benefit the North were regarded as irresponsible behavior bolstering the ailing regime. The lack of

viewpoint to explore growing economic engagement led to poor policy recommendations in managing inter-Korean relations. The conclusion of this study however demonstrated the possibility of sustainable progress of inter-Korean economic projects by examining whether and how much the major actors of inter-Korean trade were affected by the nuclear crisis. By showing that inter-Korean economic projects gave South Korean small and medium sized manufacturing industry an important survival kit, this study provided a novel viewpoint to understand inter-Korean economic transactions as a mutually beneficial interaction in the business context, not cash-pouring political action toward the ailing North Korean regime.

Thirdly, this study demonstrated, by relevant literature and interviews, that inter-Korean endeavors to pursue economic cooperation continued even during the second nuclear crisis. The efforts were made not only by South Korean actors in desperate need to secure cheaper production costs but also North Korean institutions that have declared the so-called military-first policy. The simultaneous pursuit of nuclear development and expansion of external economic engagement by the North showed that military confrontation and economic exchanges were not incompatible in the Korean Peninsula. This finding, at the analysis level, suggested that a single analytical tool could be used to shed light on the relationship between security and economy. At the policy level, at the same time, the continued pursuit to find out how to improve external economic relations by the allegedly nuclear-armed North Korean leadership indicated that economic means had a feasibility to mitigate, if not resolve, the nuclear tension. It also indicated a sequential approach meaning the idea that the nuclear crisis should be thoroughly resolved before embarking substantial level of economic cooperation is unrealistic. The

achievement of this study on the coincidence of military tension and economic cooperation could offer an appropriate base for policy analysis for not only South Korea but also all the actors involved including the United States. But the lack of this notion will in the end lead to fail to grasp the growing complexity of diplomatic relations between North Korea and the external world.

#### ***8.4 Implications for broader inter-Korean relations***

The findings in this study suggest that, under particular political conditions, the external security threat is not able to outweigh domestic business needs seeking a more favorable environment outside its territory for more profitable transactions. This study has attempted to sketch out such a political condition by borrowing the analytical concept of the complex interdependence model. In general, South-North Korean relations between 2002 and 2006 fit closely the key characteristics of the complex interdependence model. This finding resulted in bringing at least two significant conclusions as to (a) how to define the role and goal of inter-Korean engagement amid the nuclear confrontation in the Korean Peninsula (b) how to interpret the essence of the nuclear ambitions created by the DPRK between 2002 and 2006.

Firstly, this study demonstrates that fluctuation in inter-Korean economic relations during the nuclear crisis was shaped outside the military standoff caused by the crisis. In other words, the increasingly tougher military stalemate, in the long run, did not necessarily mean a dwindling inter-Korean engagement and cooperative projects. Inter-Korean relations were not merely a dependent variable bound up with the progress of nuclear negotiation even during the development of the crisis. Inter-Korean economic

cooperation indeed turned out to have its autonomous space, in which their economic relations could continue regardless of ongoing military tension, as long as the proposed joint projects were economically viable.

Since the early 1990s, how to frame a policy line on inter-Korean economic cooperation in line with the U.S.-DPRK nuclear confrontation has been a highly debatable issue in both Washington and Seoul. Washington is believed to harbor an unexpressed suspicion about the sanguine views of Seoul. They seemed to reckon that Seoul has provided Pyongyang with sufficient cash, by which it is able to muddle through in spite of Washington's containment attempts in addition to an already devastated economy (Eberstadt 2007, 159-195). Thus, in dealing with nuclear Pyongyang, Washington tended more to stress a 'universal' template that could equally be applied to any other nation with nuclear ambitions such as Iran. Economic engagement with a potential nuclear power was unthinkable for the administration.

However, its key ally in the Korean Peninsula dismissed the 'universality' argument. Policymakers in the Roh Moo Hyun administration who dealt with the second nuclear crisis largely believed that Seoul's posture for the engagement policy with Pyongyang could and should be consolidated irrespective of Washington's containment strategy toward the Kim Jong Il regime. They did not agree that inter-Korean relations, which they believed mutually beneficial, should be halted in the event of the peace and security of the Korean Peninsula being threatened by the nuclear crisis. They rather advocated the argument that economic engagement was a more efficient tool to persuade Pyongyang to conform to international norms by providing them with alternative options other than the nuclear card they had been using since the 1990s. This perception

gap between Washington and Seoul became the genesis of the cacophony between the two allies in establishing North Korea policy throughout the Roh Moo Hyun administration (Park H.J.2007, 12-19).

The conclusion of this study supports the latter argument. As the survey results demonstrated, the domestic factors that meant the business community's desire to secure a cheaper workforce and production facilities turned out to be a primary driving force to push inter-Korean trade forward during the nuclear crisis. It indicates that the external security risk in and around the Peninsula was not able to outweigh the domestic desperation of economic actors for more profitable production environment. At the same time, it dismisses the 'universality' thesis of the Bush administration in tackling the denuclearization deal by showing the potential possibility for regional actors to achieve engagement with the DPRK through economic means. Twenty years' history of inter-Korean economic cooperation opened up and consolidated such a possibility by generating mutual, not unilateral, gains between the DPRK and external actors. Particularly, the KIC projects which gave more than 40,000 North Korean people stable jobs turned economic collaboration with the DPRK into a reality.

Secondly, the finding of this study reinforces the argument that the desperation of the DPRK leadership to seek more economic resources from the external world constituted the fundamental motivation of its nuclear development. One of the findings of this study was that North Korean endeavors to revive its economy by involving external players including its neighboring South Korea peaked from 2002 to 2006 during which the second nuclear crisis was heightened. During this period, the North Korean authority knowingly condoned widespread economic deviation from its *dirigiste*

system indicating ‘marketization from below’ (Smith 2005b). On the contrary, the North Korean government began to gradually regulate eligibility of *de facto* market participants after 2006 as the nuclear crisis led Washington and Seoul to provide Pyongyang with a set of *quid pro quo* programs. Cracking down on market-oriented economic activities also coincided with the reported dismissal of North Korean economic officials who played a key role in the inter-Korean economic dialogues.<sup>56</sup> From about 2006, as a ramification, the multiple channels between the two Koreas that had contributed to shaping inter-Korean subnational level exchanges began to be closed. The conservative voices openly opposing the economic adjustment program built upon market-based ideas emerged more often than before. The arguments stressing ideological rearmament to protect the regime from capitalist encroachment began to be seen more frequently in the North Korean state media. Comparing the relatively accommodative posture of the DPRK leadership up until 2006 and the regressive mood afterwards led external observers to infer that the real goal of North Korea’s nuclear game was more economic concessions from the external world in general and South Korea in particular. Some empirical information actually shows that the bigger Pyongyang’s desperation for external economic support grew, the tougher their nuclear threat became. The DPRK leadership continued to send Seoul a conciliatory signal in terms of inter-Korean economic engagement at the same time as they heightened nuclear tension toward Washington. In doing so, Pyongyang took advantage of various quasi-

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<sup>56</sup> In the meantime, media reports quoting unnamed North Korean sources were spread that the North Korean negotiator, Choe Sung Chul, who played a key role in arranging the Roh Moo Hyun - Kim Jong Il summit has been either sent to a re-education camp or executed. The sources stated that his dismissal could be prompted by his misjudgement on the policy toward the ROK or personal corruption scandals with engaging with the South (*Dong-A Ilbo* 19<sup>th</sup> May 2009).

governmental channels they had established since 2000 to pursue cooperative projects with Seoul by giving them power and discretion. To put it differently, this five years period, during which the nuclear tension had culminated, could be paradoxically portrayed as the time when complex interdependence was embodied fairly well when it comes to inter-Korean relations.

Critics of this claim, on the other hand, emphasized that Pyongyang has employed a so-called 'divide and cope' strategy to pursue two goals -- economic survival and security stability -- at the same time to sideline South Korea in the nuclear negotiation (Kim K.R. et al. 2007, 34). According to them, as Pyongyang's nuclear deal with Washington went into trouble, the North Korean leadership showed a tendency to take advantage of Seoul's compassionate sentiment by repeatedly emphasizing homogeneity between the two Koreas. They insisted that the slogans such as '*minjok kongjo* (national cooperation)' or '*Uri minjok kkiri* (by the joint efforts of the entire Korean people)' frequently seen in their state media alluded to Pyongyang's 'divide and cope' strategy dealing with Washington and Seoul separately. Central to their claims was that the DPRK pursued economic cooperation with the ROK only when they were driven to the last ditch in the nuclear negotiation, with the purpose of securing enough cash to survive confrontation with the United States.

However, this claim was hard to prove even though it is not totally unfounded. In order to demonstrate that the 'divide and cope' strategy by Pyongyang was its consistent posture since they had embarked on nuclear development, above all, a similar strategy must be shown to have been pursued during the first nuclear crisis in the 1990s. But little evidence was provided in the 1990s that the DPRK pursued a substantial economic

engagement policy with the external world. They showed neither intention nor readiness to accept trade and investment from its southern neighbor. The changed attitude of the DPRK during the second nuclear crisis in terms of how to deal with foreign economic resources and power showed that the second crisis could not be interpreted without paying sufficient attention to its economic atrophy. This study thus provides one of the explanatory tools to understand why the heightening of the nuclear tension engineered by the DPRK leadership and more economic engagement coincided.

### ***8.5 Theoretical framework revisited***

This study adopted the complex interdependence model to capture the essence of the substantial change in inter-Korean relations after 2000 as the background against which a wider range of inter-Korean exchanges was carried out. The model was proposed and developed from the 1970s to the 1990s in an attempt to interpret a newly emerging pattern of state interactions which had begun to replace the traditional, security and power-balance dominated world order. Given the fact that inter-Korean relations were largely built upon unsettled military dynamics even after the demise of the Cold War, it was true that this new analytical tool is not likely to gain indisputable support from IR scholars and policymakers dealing with military-centered regime dynamics. But, on the other hand, the model provided an alternative means to observe the way in which sub-national or quasi-governmental actors in the two Koreas engaged with one another as a result of the 2000 inter-Korean summit which could have hardly been explained by the existing realism-based analytical methods.

International political theory focusing on economic interdependence was the product of the ever expanding development of international political economy in the 1970s and 80s. From the viewpoint of conventional IR theories, economic interdependence was by no means tantamount to diplomatic leverage to be able to deter one's counterpart. It was able neither to prevent security threats nor to jeopardize its enemy. But from an IPE perspective, asymmetric economic interdependence could have potential power over the other party's behavioral patterns depending on political bargaining (Keohane and Nye 1989, 11). In this sense, the attempts to interpret the ROK government policy toward the DPRK by employing the complex interdependence model appropriately reflected the change in inter-Korean relations that had involved ever growing economic interactions. The Kim Dae Jung and Roh Moo Hyun administrations' consistent engagement efforts with the DPRK were alike built upon the belief that shared interests created by economic exchanges are likely to have a potential either to eliminate or to diminish security instability in the Korean Peninsula.

Despite the analytical convenience that the complex interdependence model provided, however, it is by no means a completely pertinent tool kit to analyze the essence of inter-Korean affairs from 2002 to 2006. It rather needs to be refined to fully explain the ROK government's unchanged capacity in determining the scale and pace of inter-Korean economic engagement in consideration with overall security dynamics in the Korean Peninsula and beyond. It is also clear that, in the context of the interrelationship between security and economy, economic considerations in the Peninsula are not entirely likely to outweigh security concerns. Further reformulation will therefore be needed to embrace these points that the complex interdependence

model did not fully take into account in order to scrutinize this inter-Korean case of economic engagement.

It is not the case that various elements in inter-Korean relations made equal contributions to frame the relations at all times since the summit in 2000. Indiscriminately combining all the aspects involved in inter-Korean affairs is another misleading approach in identifying a key force that has driven the trajectory and reality of the relations. It is thus important that one acknowledges the military tension was accepted with different impact and strength depending on the level of interdependence in particular period. But the complex interdependence model did not explain under what conditions military tension is either highlighted or overshadowed by many other interactions that reinforced interdependence between states.

Military capability in both South and North Korea is a still essential source of power for self-defence. The Yellow Sea naval conflict which occurred in June 2002 that left six South Korean sailors dead provided a good example. This incident abruptly broke out while the two Koreas were enjoying the thaw following the inter-Korean summit two years previously. What became more salient was the fact that this unprovoked fighting revived a hostile mood in the South Korean public opinion toward inter-Korean economic exchanges. Political opponents of the Kim Dae Jung administration stepped up their campaign arguing the cash delivered to the North as the reward for the economic exchanges ultimately resulted in killing South Korean soldiers. Although this skirmish did not create a decisive obstacle in the post-summit inter-Korean relations, it reminded the relevant actors that relations may well become fragile again in the event of a recurrence of military insecurity. Unfinished military

confrontation and intermittent clashes created a situation where the realist assumption could be more persuasive in dismissing the applicability of the complex interdependence model. In this sense, framing the theoretical debate over economic exchanges and political conflict in terms of a paradigmatic clash between liberalism and realism would not be appropriate in accounting for inter-Korean relations.

Whereas the complex interdependence model stressed the absence of a clear and consistent hierarchy of issues in foreign policy, the case of inter-Korean political and economic relations implies that a hierarchy still existed in an implicit way. In other words, the security threat from the North, whether it was an attempt to extract diplomatic concession or a real effort to build up military muscle, had the potential to determine the conditions of progress in many other non-security issues. It meant that the two Koreas did not reach the situation where non-security national interests, economic benefits from the other for instance, could constantly outweigh security concerns. On either side, there was a possibility that the implicit hierarchy could surface depending on the change of security dynamics surrounding the region. However, the dominant factor to affect when and under what conditions the implicit hierarchy reappears is not the foreign policy climate made by the external regional players but the internal regimes of the individual players.

What was more central was the South Korean government's firm posture in preventing the second nuclear crisis from developing into destruction of inter-Korean economic reciprocity that had been accomplished since the early 1990s. The Kim Dae Jung and Roh Moo Hyun administrations continued to support inter-Korean economic engagement despite growing domestic opposition demanding either suspension or

reduction of the scale of any activities believed to give Pyongyang economic gain. The consistent efforts to maintain the momentum of inter-Korean economic cooperation prevented security concerns from dominating again the hierarchical order in South Korean foreign policy toward North Korea.

However, the Lee Myung-bak administration that took office in 2008 made clear that it would no longer pursue 'unconditional' economic engagement with Pyongyang. Instead, it placed the denuclearization commitment of the DPRK at the top of the agenda and charted a 'conditional reciprocity' strategy subject to Pyongyang's willingness to abandon its nuclear program (Snyder 2009, 14-22). This substantive change of the ROK government's attitude toward the DPRK brought about the re-emergence of hierarchical order in the agenda setting strategy of North Korea policy. Progress in inter-Korean economic cooperation was significantly hampered with increasing concern over unsettled nuclear tensions since Lee Myung-bak, who had once labelled his predecessors' North Korea policy a 'lost decade', came to power.

On the North's side, a series of measures from about 2006 were put in place to crack down on the spontaneous market-based economic activities at which they had implicitly connived since the great famine in the 1990s. It was understood as an effort by the North Korean leadership to prevent ideological contamination through the influx of external information and to emphasize the moral superiority of its own economic system. As the Lee Myung-bak administration adopted a substantially different approach on inter-Korean economic exchanges from his predecessors, the North's rhetoric toward the South became even more belligerent. They took a set of actions likely to endanger the existing cooperation track in return for the new South

government's lukewarm attitude in maintaining the inter-Korean business capacity as large as that of the Kim Dae Jung and Roh Moo Hyun administrations. In December 2008, the DPRK made an announcement to expel ROK government officials from the consultation office of the inter-Korean economic cooperation office in the KIC. The DPRK also reduced the number of South Koreans staying in the Complex by half. Inter-Korean trade as a result plunged nearly 25 percent in the first four months in 2009 (*Yonhapnews* 9<sup>th</sup> June 2009).

Lee Myung-bak's commitment to differentiate his policy from his two predecessors' engagement approach rooted on the 'Sunshine Policy' was formed on the basis of the majority of his supporters group opposing the Kim Dae Jung and Roh Moo Hyun policy. Although Lee Myung-bak initially labelled his policy as pragmatism, conservative domestic public opinion urged that more priority ought to be given to the dire security crisis created by the North Korean nuclear program.

Even in the North Korean regime, domestic factors constituted one of the claims that explained the troubled relationship with the South. There has been a great deal of publicity surrounding Kim Jong Il's critically ill health since summer 2008. Kim Jong Il's health problem caused much speculation that it was highly likely that the North's military circles would take over a key role in managing not only the nuclear deal but also inter-Korean relations (Cheong S.C. 2009). It was none other than North Korea's chief military negotiator in inter-Korean talks who announced a series of hard-line economic measures (*The Hankyoreh* December 18<sup>th</sup> 2008). The intervention in inter-Korean economic relations by the North Korean military provides evidence showing the

economic issues in the DPRK are highly related to the internal regime stability linked to security concerns.

On balance, examining each side's internal political dynamics is essential to capture when and by which pattern the implicit issue hierarchy reappears. The problematic points of the complex interdependence model to explain inter-Korean case, in other words, can be refined by careful scrutiny of each player's domestic environment. After all, the environment will contribute to crafting each individual player's foreign policy agenda and its impact toward each other. Analytical observation of internal political dynamics should be a core point in the reformulation of the complex interdependence model as an analytical framework to shed light on the present and future of inter-Korean relations.

### ***8.6 Policy implication on the ROK government***

The conclusion of this study shows that there was no particular and direct causal relationship between the nuclear crisis and inter-Korean trade. It gives the ROK government a lesson that an attempt to make use of economic leverage to gain advantage in a nuclear deal is unlikely to bring an intended result. In other words, any endeavor for the ROK government to adjust the pace and scale of inter-Korean trade by using the leverage in an attempt to dissuade Pyongyang from further developing its nuclear program is not likely to succeed. Instead, it stresses the necessity of consistent patience by the ROK government in dealing with economic relations with the DPRK, not mobilizing economic means with immediate effect to try to coerce Pyongyang. The policy implication to be drawn from this finding is that the ROK government needs to

acknowledge that economic cooperation with the DPRK is not a diplomatic tool to seek politically higher ground in the relevant negotiation. Rather it gives the ROK government a message that inter-Korean economic cooperation should be understood as a buffer zone to prevent a further deterioration of political relationship between the two hostile countries.

Inter-Korean economic exchanges and cooperation have dual and complex features in the context of the overall relationship between the two Koreas. It is above all a commercial transaction undertaken on the basis of pure profitability as the first and foremost driving force. But the other side of the coin shows that it needs a proactive intervention by government in the light of its contribution to the reconciliation of inter-Korean relations and beyond. The latter however does not mean that the government should control or take over inter-Korean economic transactions at the business level. What is needed for the ROK government in this sense is to orchestrate the conditions of inter-Korean engagement in order for entrepreneurs to easily access human and natural resources in the DPRK.

As long as the SMEs play a major role in inter-Korean business, the policy focus of the ROK government should be supporting their own domestic interests associated with commercial transactions with the DPRK. It means the role of government intervention should not go beyond that of a facilitator to guarantee the stable flow of resources between the two parties. It is neither possible nor desirable for the ROK government to be a regulator that controls all the conditions of these commercial transactions. The government's role as a facilitator could also be justified in light of the key features of the North Korean market. It is demanding for private firms to acquire

profitability and productivity at the same time in an underdeveloped market like the DPRK (Hong S.J. 2004). Government support for the SMEs' business with North Korean counterparts in this context is unavoidable for a certain length of time. This policy direction fits also well with the ROK government's stance in dealing with Pyongyang through means of economic engagement. The ROK governments since 1990, no matter how hawkish or dovish, have believed that using economic means is likely to bring about productive changes in the DPRK system. They have advocated (Noland 1999, 96-97) that a desirable solution could be achieved when the DPRK pays sufficient heed to trade through which it could materialize comparative advantage. Promoting the South Korean SMEs to launch business with DPRK counterparts at various areas constituted one of the key policy leverages of the ROK government in striving for substantial change in Pyongyang.

### ***8.7 Recommendation for future research***

This study has challenged the inclination that Korean studies had shown in the past, which was dominated by the dichotomy of being separately focused on security and economy. Instead, this study paid intensive attention to how the change of security dynamics affected economic interactions between the two potentially hostile countries. Such an approach led to expanding the main research agenda of the existing Korean studies by exploring inter-relations between security and economy under unstable military dynamics. In terms of the main actors in such an interaction between security and economic transactions, this study observed the South Korean SMEs' pattern of behavior to see how they responded to the mounting security tension. Consequently this

study will provide a platform for researchers to focus on a non-state, subnational actors-centered approach in inter-Korean politics which had previously attracted less attention in Korean studies. Taking the importance of so-called track-two diplomacy<sup>57</sup> into account will also lay the foundation for a better understanding of the nature of increasing inter-Korean exchanges.

On this basis, future research in Korean studies in association with the DPRK needs to place more emphasis on various elements outside the conventional military dynamics. Among the elements, human rights, humanitarian/development aid, capacity building, social insecurity, and the likelihood of economic transformation are likely to constitute the research agenda. This particular study moreover shows that efforts should be made in two dimensions.

Firstly, the range of actors in inter-Korean exchanges, as a main research theme, in terms of how they reshaped inter-Korean relations, needs to be diversified. It is true that non-state actors such as civil organizations and private firms are not decisive players that brought about a dramatic and sweeping transformation of the political environment in the Korean Peninsula. However, the experience of the twenty years' history of inter-Korean economic exchanges indicates that North Korean society has become more susceptible to external economic relations. Hyundai's crucial role in engineering the inter-Korean summit and its continued and exclusive engagement with the DPRK top leadership requires a new look at the significance of the back channel network, created by non-state actors, in dealing with North Korea. The socioeconomic change of the DPRK in part reported by the growing number of defectors who settled in the ROK

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<sup>57</sup> For a well-defined explanation on track-two diplomacy in the international politics, see Montville (1991) and for its application to the case of the DPRK, see Cuthbert (2005) and Burgharts (2009).

should also be further investigated to reveal the whole aspect of internal mechanism of the DPRK.

Secondly, within the realm of inter-Korean economic activities, future research should pay more attention to the consequences and impact of such activities on the North Korean internal system. Research questions should include the extent to which South Korean economic engagement efforts affected the North and the direction to which the engagement contributed in framing the North Korean foreign policy. Exploring whether the economic engagement policy caused constructive change in the DPRK or rather strengthened its ailing regime by offering a life-support system would be another worthwhile question to be answered in dealing with the economic side of the engagement.

Additionally, a longer period of observation and/or an investigation into the different aspects of inter-Korean subnational level engagement will be needed to overcome the limitation of this study based on single case analysis from the ROK side. This effort may reveal how the various domestic actors on both sides are differently affected by the repetitive pattern of the security crisis in the Korean Peninsula. In the end, such an effort will lay a foundation on which new conceptual synthesis comes up to better explain how and to what extent economic interdependence affects interstate conflict.



## Appendix

### Questionnaire

As a PhD student in the Department of Politics and International Studies, the University of Warwick in the United Kingdom, I am now conducting a research project focusing on 'the role of the South Korean small and medium sized enterprises in the inter-Korean trade after nuclear crisis in 2002'. I am writing to ask for your participation in this project by answering the questions below. All the questions are related to your own decision making and judgement regarding your inter-Korean business from 2002 to 2006. Your answer will definitely be kept confidential and the information collected by this questionnaire will be used for research purpose only. Your cooperation would be highly appreciated. If you have any queries, please do not hesitate to contact me.

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#### **Section1 . Influence of the 2002 nuclear crisis on the inter-Korean trade (1-6)**

1. To what extent, was your inter-Korean trade been affected by a series of security instability caused by the North Korean nuclear program which was revealed in 2002 ?

- a. Never been affected
- b. Not affected
- c. Not sure
- d. Affected
- e. Seriously affected

2. Did the volume of your trade with the DPRK change between 2002 and 2006?

- a. Increased
- b. Not changed
- c. Decreased

2-1. (For those who answered 'a' and 'b' in the question 2) What were the most important reasons to do so ? (You can choose more than one)

- a. Governmental support including the Inter-Korean Cooperation Fund
- b. Domestic factors including the worsening business environment in the ROK
- c. External factors including the North Korean economic reform measures announced in 2002
- d. Others ( )

2-2. (For those who answered 'c' in the question 2) What were the reasons? (You can choose more than one)

- a. Uncertain profitability
- b. Concern for the exacerbating security stability
- c. Hostile public opinions in the ROK
- d. Requirement of the trade partners in the DPRK
- e. Others ( )

3. Did the ROK government intervention including the Inter-Korean Cooperation Fund influence your decision-making ?

- a. Yes
- b. Not sure
- c. No

3-1. (For those who answered 'a' in the question 3) Which aspect of the Government's decision to revitalize the Inter-Korean Cooperation Fund was the most important factor in your decision ? (You can choose more than one)

- a. Compensation mechanism of profit loss
- b. Reducing the interest rate of the loan
- c. Expansion of the loan facility
- d. Others ( )

3-2. Do you think you maintained the volume of the inter-Korean trade as planned when assuming that there was no change in the government guideline on the inter-Korean cooperation fund?

- a. Yes
- b. No
- c. Not sure

4. Did the domestic business environment in the ROK influence your decision making ?

- a. Yes
- b. No
- c. Not sure

4-1. (For those who answered 'a' in the question 4) Which aspect of the ROK business environment had the biggest influence on your decision ? (You can choose more than one)

- a. High labor cost
- b. High land cost
- c. Trade union activities
- d. Others



- b. Direct contact between the firms in the South and their counterparts in the North
- c. Indirect contact between the two parties through the intermediary body in the third country

10. Do you think the policy priority of the ROK government was changed in dealing with the DPRK issues after the inter-Korean summit talk in 2000 ?

- a. Yes
- b. No
- c. Not sure

11. Do you think the military tension in the Korean Peninsula was changed after the inter-Korean summit in 2000 ?

- a. Yes
- b. No
- c. Not sure

12. Do you think the ROK government policy on the inter-Korean trade had a positive effect on your business toward the DPRK?

- a. Yes
- b. No
- c. Not sure

12-1. (For the respondents who answered 'a' in the question 12) What was the most positive factor in providing more congenial environment for the inter-Korean business?

- a. Pursuit of the Kaeseong Industrial Complex project
- b. Inter-Korea railway reconnection
- c. Inter-Korean agreement for light industry in 2004
- d. Others

13. What was the key organization apart from the ROK government that affected your trade with the DPRK positively?

- a. Local authority
- b. Small Business Corporation (SBC) in the ROK
- c. Korea International Trade Association (KITA)
- d. Trade partners in the DPRK
- e. Other firms in the ROK involved in the inter-Korean trade
- f. Others

14. Did you take the non-business factors into account, such as peaceful coexistence, reconciliation between the two Koreas, along with your profitability in pursuing the inter-Korea trade ?



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